SUPREME COURT, U. S.

FILED
JUL 14 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1967.

No. 366

AMERICAN INVESTORS FUND, INC.,

Petitioner,

v.

ROSALIND FOGEL and GERALD FOGEL,

Respondents,

and

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.) and JESUP & LAMONT,

Defendants.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	5
Reasons for Granting the Writ	10
Conclusion	19

TABLE OF AUTHORITIES

Cases:

J. I. Case Co. v. Borak, 377 U.S. 426 16

Cohen v. Beneficial Industrial Loan Corporation, 337 U.S. 541 ..... 2, 10, 15, 18

Entel v. Allen (64 Civ. 4048, S.D.N.Y., January 31, 1967) —— F. Supp. ——, reported CCH Federal Securities Laws, ¶91,886 15

Erie R.R. Co. v. Tompkins, 304 U.S. 64 18

Mintz v. Allen, 254 F. Supp. 1012 15

Phelps v. Burnham, 327 F. 2d 812 (2d. Cir.) 18

Saxe v. Brady, 40 Del. Ch. 474, 184 A. 2d 602 16

United Mine Workers v. Gibbs, 383 U.S. 715 ..... 12, 13, 14, 15, 17

PAGE

Other Authorities:

Business Corporations Law of New York, Section 627 (9 McKinney's Cons. L. of N.Y. Sec. 627) 1, 3, 9, 10, 12

The Rules of Decision Act, 28 U.S.C. 1652 4

Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1, et seq.) 4, 5, 6, 7, 8, 11, 13

S.E.C. Report to Congress of December 2, 1966 ("Public Policy Implications of Investment Company Growth", 89th Congress, 2d Session, Union Calendar No. 1046, House Report No. 2337) 9, 15, 16, 17, 18

115 Univ. of Penn. L. Rev. 659, 740, 753 17

Rule 8, F.R.C.P. 13

Rule 30(b), F.R.C.P. 5

INDEX TO APPENDIX

	PAGE
Notice of Motion	1a
Affidavit of John F. Newton (Sworn to February, 15 1967 in Support of Motion)	4a
Complaint (Original)	14a
Amended Complaint (First paragraph only, remainder being identical to original complaint)	25a
Memorandum Decision and Order of District Court	25a
Order of Affirmance of Court of Appeals	27a

In The

Supreme Court of the United States

October Term, 1967.

No.....

American Investors Fund, Inc.,

Petitioner,

v.

Rosalind Fogel and Gerald Fogel,

Respondents,

and

George A. Chestnutt, Jr., John Currier, Frank G. Fowler, Jr., Warren K. Greene, Richard W. Radcliffe, Stanley L. Sabel, Elizabeth Sullivan, Francis L. Veeder, American Investors Corporation, Chestnutt Corporation, The Fund of Funds, Ltd., I.O.S., Ltd. (S.A.) and Jesup & Lamont,

Defendants.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner American Investors Fund, Inc. prays that a Writ of Certiorari be issued to review the decision of the United States Court of Appeals for the Second Circuit which summarily affirmed the decision of the District Court which had denied petitioner's motion in a stockholders derivative action for security for reasonable expenses, including legal expenses, under Section 627 of the

Business Corporations Law of New York, for an allegedly "pendent" state claim, or, in the alternative, to dismiss the state claim as not being properly "pendent" to purported federal claims.

Opinions Below

The decision of the Court of Appeals was rendered May 8, 1967. It is unreported and is printed at App. p. 27a*. The memorandum decision and order of the District Court was filed March 30, 1967. It is unreported and is printed at pp. 25a-26a.

Jurisdiction

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and 28 U.S.C. 2101(c). Jurisdiction is further invoked under this Court's decision in *Cohen* v. *Beneficial Industrial Loan Corporation,* 337 U.S. 541.

Questions Presented

The first question presented is whether in a stockholder's derivative action plaintiffs are required in accordance with state law to post security for reasonable expenses, including legal expenses, in "pendent jurisdiction" cases, as well as in "diversity" cases as required by *Cohen* v. *Beneficial Industrial Loan Corporation,* 337 U.S. 541.

The second question, in the alternative, is whether the state claim should have been dismissed as not deriving from a common nucleus of operative fact with the purported federal claims.

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* Pages of appendix, bound with this petition, are designated by letter "a".

The third question presented is whether the Court of Appeals properly affirmed summarily on motion the decision of the District Court, without full briefs and the record of the District Court before it, denying petitioner's motion for the relief in the first two questions.

Statutes Involved

Section 627 of the Business Corporations Law of New York (9 McKinney's Cons. L. of N.Y. Sec. 627) provides:

> "§627. Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor
>
> "In any action specified in section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), if the plaintiff or plaintiffs hold less than five percent of any class of the outstanding shares or hold voting trust certificates or a beneficial interest in shares representing less than five percent of any class of such shares, then unless the shares, voting trust certificates and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable under this chapter, under any contract or otherwise under law, to which the corporation shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon

showing that the security provided has or may become inadequate or excessive. L.1961, c. 855; amended L.1962, c. 834, Sec. 43, both eff. Sept. 1, 1963."

The Rules of Decision Act, 28 U.S.C. 1652, provides:

"§1652. The laws of the several states, except where the Constitution or treaties of the United States, or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

Section 10(d) of the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1, et seq.), provides:

"(d) Notwithstanding subsections (a) and (b)(2) of this section, a registered investment company may have a board of directors all the members of which, except one, are affiliated persons of the investment adviser of such company, or are officers or employees of such company, if—

"(1) such investment company is an open-end company;

"(2) such investment adviser is registered under subchapter II of this chapter and such investment adviser is engaged principally in the business of rendering investment supervisory services as defined in said subchapter II;

"(3) no sales load is charged on securities issued by such investment company;

"(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

"(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

"(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

"(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

"(8) such investment company has only one class of stock outstanding, each share of which has equal voting rights with every other share."

Statement

This petition seeks review of an order of the Court of Appeals which summarily affirmed the memorandum decision and order of the District Court denying petitioner's motion for a protective order under Rule 30(b) of the Federal Rules of Civil Procedure, or in the alternative, to dismiss the "pendent" state claims. The protective order sought to compel plaintiffs to furnish a bond in the amount of $100,000 under New York law as security for expenses and legal fees in this shareholders derivative action, or in the alternative to dismiss the state claim.

Petitioner is a New York corporation and is a "no-load" mutual fund (pp. 4a, 6a).

It is a registered investment company under the Investment Company Act of 1940 (the "Act"), and there is no allegation in the complaint that it fails to meet each and every requirement in the eight numbered subparagraphs of Section 10(d) of the Act (quoted *supra*, pp. 4-5).

Among these requirements is that of Subsection 10(d)(6) that any management or advisory fee charged shall not exceed one percent per year, as defined.

The complaint in paragraph "5(b)" correctly alleges that petitioner has paid investment advisory fees annually of 8/10ths of one percent on the first $50,000,000 of net assets, 6/10ths of one percent on the next $50,000,000, and 4/10ths of one percent on the next $100,000,000 (p. 16a). The record shows that at the time of the motion petitioner's net assets were approximately $110,000,000 (p. 9a).

Notwithstanding the fact that petitioner has always met the requirements of the eight numbered subparagraphs of Section 10(d) of the Act, petitioner has also complied with the provisions of Section 10(a) of the Act, which provides that not more than 60 percent of petitioner's directors may be "affiliated persons," as defined in the Act, instead of having only one non-affiliated director which is permitted to an investment company not charging more than a one percent advisory fee. Thus, it is doubly certain that the rate of advisory fee paid by petitioner is legal under the Act, since there is no limitation on such advisory fee where no more than 60 percent of the directors are affiliated, and, in any event, petitioner has paid less than the one percent fee which it could have paid had there been only one unaffiliated director.

There are no allegations in the complaint that petitioner does not have the proper number or percentage of unaffiliated directors. "Affiliation" is not mentioned. Hence, as a matter of federal law, the rate of the advisory fee is not justiciable under the complaint.

Plaintiff's original complaint, which was amended during the pendency of the motion, alleged in paragraph "1" (p. 14a):

"1. This action arises under the Investment Company Act of 1940, 15 U.S.C. Sec. 80 a-1, et seq. (the "Act") and common law principles. The jurisdiction of the court is based on the Act and on the principles of pendent jurisdiction."

Plaintiffs, therefore, clearly realized that their complaint was based on state law. There are no allegations of diversity of citizenship.

As is set forth below under "Reasons for Granting the Writ," petitioner contends that the only real thrust of the complaint is an action for violation by directors of fiduciary obligation under New York law. Petitioner further contends that the invocation of the Investment Company Act of 1940 is insubstantial at best, and in any event relates only to a portion of the complaint.

Following the making of the motion for security for expenses and legal fees under New York law, plaintiffs filed an amended complaint, amending only Paragraph "1" of the complaint quoted above, so as to delete the reference to "pendent jurisdiction" and "common law principles." (p. 25a)

Thus, the substance of the complaint remains the same after the amendment as it was before.

There are three entirely separate claims in the complaint, and the three claims are totally unrelated in law or in fact. After identification of the parties and an allegation of stock ownership in the first four paragraphs, paragraph "5", containing nine sub-paragraphs, attempts to set forth an action for violation of fiduciary duty under New York law.

A totally different claim is alleged in paragraphs "6" through "11". There the plaintiffs seek to allege that petitioner's agreements with its investment adviser are illegal

and void because the directors of petitioner are said to be under the domination and control of the investment advisers and the stockholders were not informed. The plaintiffs say that this constitutes a violation of Section 10(a) and Section 15 of the Act. There are no grounds or facts set forth to show such domination.

The third segment of the complaint, a third claim, alleges that payments by petitioner of brokerage fees to a brokerage firm were improper, although there is no claim that the brokerage paid was other than the customary brokerage, and there is no claim that it was unnecessary, or that petitioner engaged in "churning" its portfolio (paragraphs "12" through "20").

The state law claim culminating in the allegations of paragraph "5" is nothing more than New York boiler plate allegations of waste in violation of fiduciary duty. The second and third claims purport, in conclusory language, to state that the federal statute had been violated. However, there is no allegation in the second claim (paragraphs "6" through "11") that the directors of petitioner were not chosen in accordance with the Act, or that there were not the requisite number of unaffiliated directors. The third claim cannot really be said to allege any damage to petitioner, since there is no allegation of unnecessary brokerage payments, nor is there any allegation that petitioner paid excessive brokerage commissions.

Thus, the only claim in the complaint which alleges damage to petitioner, and for which plaintiffs derivatively seek recovery, is the first claim for violation of fiduciary duty in paragraph "5". Everything following that paragraph purports to set forth abstract and conclusory claims of illegality under federal law, thus affording a purported vehicle for federal jurisdiction, although without any showing of injury to petitioner.

The short moving affidavit by petitioner's Treasurer states facts tending to show that there is no common nucleus of operative fact for the State claim and the purported federal claims (pp. 4a-13a). It states the facts of the minute shareholdings of respondents, making mandatory the relief under Section 627 of the Business Corporations Law (p. 5a).

The affidavit outlines the spectacularly successful investment record of petitioner, one of the best of all the investment companies in the world for the last five years, according to a recognized statistical authority (pp. 9a-10a). It is shown that the appreciation in value per share of petitioner has been more than four times that of the Dow-Jones Industrial Average over a period of years, and that in 1966 when that average declined 18.9%, petitioner's share value appreciated 3% (p. 9a).

The affidavit emphasizes the fact that petitioner is a "no-load" fund (p. 6a). As such, it is not the object of Securities and Exchange Commission attack and congressional attention, since as the S.E.C. report to Congress of December 2, 1966 ("Public Policy Implications of Investment Company Growth", 89th Congress, 2d Session, Union Calendar No. 1046, House Report No. 2337, hereinafter referred to as the "S.E.C. Report") states (p. 53):

> "From the small investor's point of view the sales load is by far the principal cost of a mutual funds investment. Most mutual fund investors are small investors, and the 8.5 percent sales load that they normally pay is—assuming that the net asset value of the fund's shares does not change—almost 19 times their pro rata share of the customary annual advisory fee of one-half of 1 percent." (Footnotes omitted).

Thus, should Congress adopt a 5% limitation on "sales loads" as recommended by the S.E.C. Report, petitioner's annual advisory fee, beginning in the first bracket at

8/10ths of 1%, and now in the 4/10ths of 1% bracket, will continue to present only a fraction of the expense to investors of a "load" fund, even after future remedial action by Congress with respect to the "load" funds (pp. 8a-9a).

The affidavit requests security for reasonable expenses in the amount of $100,000, including the expenses petitioner will incur in reimbursing the officers and directors who are co-defendants (pp. 5a-6a, 13a).

The affidavit makes clear that the defense of the state equity claim will be detailed, massive and expensive, whereas the purported federal claims, since they involve wholly different facts and narrow legal issues, will be relatively less expensive to defend before a jury (p. 13a).

Reasons For Granting the Writ

If petitioner is entitled to the protection of Section 627 of the Business Corporations Law of New York, which was enacted to prevent "strike suits" and to relieve corporations of the heavy burden of defending baseless actions brought for ulterior motives by persons with no real interest in the outcome, then relief must be granted on this petition, or it can never be granted.

This Court has held that in "diversity" cases, a federal court must apply a state security statute. *Cohen* v. *Industrial Loan Corporation,* 337 U.S. 541. As that case pointed out, if relief is not granted during the course of a derivative action, it will be too late after the action is successfully defended, because the corporation and the officers and directors whom it must indemnify will never be able to recoup the enormous expense of their successful defense. In effect, the basis of jurisdiction and the reason for relief were held to be the same.

One judge in the Southern District of New York has held expressly that the New York requirement for security for expenses must be applied in "pendent jurisdiction" cases as well as in "diversity" cases* Apparently, other courts have not passed on the question. Since this Court has never passed on the question, it ought to do so now, even in the absence of any express conflict among the circuits, since it is a question which will recur. Failure to apply the state security statutes will increase the flooding of federal courts with essentially state actions, which, as here, are garnished with various federal securities law labels as the ticket for admission to the federal court and the passport of evasion of well considered state statutes expressing the policies of the states.

The question will recur irrespective of any action by Congress to amend the Act and involves all federal statutes.

The Act expressly recognizes in Section 10(d) quoted *supra*, pp. 4-5, that a "no load" fund, such as petitioner American Investors Fund, which does not charge any sales load or commission, may pay an advisory fee of not more than 1% per annum of its net assets, even if only one director is "unaffiliated." If not more than 60% of the directors of an investment company are "affiliated persons," as that term is specifically defined in Section 2(a)(3) of the Act, there is no limit whatever on the amount or rate of the advisory fee in the federal statute.

The complaint is wholly silent as to the affiliation of directors, and it does not attack the truth of prospectuses and proxy statements showing petitioner has never had directors, more than 60% of whom were affiliated.

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* See *infra* p. 15. Another judge has followed this decision.

Thus, it is clear at the outset that a claim of an excessive fee, which the very terms of paragraph "5(b)" of the complaint show to be less than the only federal statutory maximum, cannot be entertained under federal law. The claim in paragraph "5" of the complaint, since it cannot allege a violation of federal law, is not, and can never be, anything more than a claim of violation of fiduciary duty by directors under New York corporation law.

That the real essence of the claim in paragraph "5" is a violation of state law, and state law only, makes it clear that this claim should never have been presented to a federal court, in the absence of diversity. Of course, had the claim been brought in the state court by these holders of approximately 50 shares out of 3,250,000 outstanding at the time this motion for security was brought, petitioner could have invoked Section 627 of the Business Corporations Law as a matter of right, and a New York court would have enforced its mandatory provisions (p. 5a).

Respondents recognized that their complaint was in essence one of New York law, since they expressly invoked in paragraph "1" of the original complaint "pendent jurisdiction" and "common law principles." (p. 14a)

This Court has recently reviewed the requirements for "pendent jurisdiction." In *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725, the Court stated:

> "The state and federal claims must derive from a common nucleus of operative fact."

The present case presents a complaint where the three claims are wholly unrelated. There is no "common nucleus of operative fact" among the three claims.

The complaint is a conglomerate. Nothing tending to prove or disprove the state claim of violation of fiduciary

duty with respect to the reasonableness of the advisory fee has any bearing whatever upon the second and third claims. The second claim herein (paragraphs "6" through "11"), is nothing but an abstract assertion that all of the directors are subject to "domination and control" (paragraph 8) and that they are "beholden" to the investment adviser for the "substantial emoluments derived from their positions" (paragraph "7"). There is not a single fact or "ground" alleged, as required by Rule 8 of the Rules of Civil Procedure, and nothing tending to show or to prove the first claim as to the unreasonableness of the advisory fee would have any bearing upon the second claim.

The third claim contained in paragraphs "12" through "20" is likewise unrelated to the first claim under New York law. That third claim merely alleges that petitioner has given brokerage business to a certain brokerage firm at the request of a very large shareholder of the Fund. There is no allegation that any of such brokerage business was unnecessary, or improvident, or that petitioner paid excessive brokerage fees. The third claim is nothing but a bald statement that it is illegal for petitioner to place brokerage business at the suggestion of a shareholder, followed by the further bald assertions that this constitutes "conversion" and a deprivation of benefits to petitioner.

Therefore, this conglomerate complaint is nothing more than an allegation that the advisory fees are unreasonable, to which the plaintiffs have seen fit to tack on highly speculative assertions as to the Act.

This Court said in *United Mine Workers* v. *Gibbs*, *supra* at 726:

> "Its [pendent jurisdiction's] justification lies in considerations of judicial economy, convenience and fairness to litigants; if these are not present a federal

court should hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them, Erie R. Co. v. Tompkins, 304 U.S. 64 (58 S. Ct. 817, 82 L. Ed. 1188). *Needless decisions of state law should be avoided both as a matter of comity and to promote justice between the parties, by procuring for them a surer-footed reading of applicable law.*" (Emphasis added, footnote omitted).

• • •

"Similarly, if it appears that the state issues substantially predominate, whether in terms of proof, of the scope of the issues raised, or of the comprehensiveness of the remedy sought, the state claims may be dismissed without prejudice and left for resolution to state tribunals."

Since respondents expressly invoked "pendent jurisdiction" in their original complaint, and since their amended complaint makes no change whatever except to delete such reference in the first paragraph, the further statement of this Court in *United Mine Workers* v. *Gibbs, supra,* at p. 727 is especially significant:

"The question of power will ordinarily be resolved on the pleadings. But the issue whether pendent jurisdiction has been properly assumed is one which remains open throughout the litigation. Pretrial procedures or even the trial itself may reveal a substantial hegemony of state law claims, or likelihood of jury confusion, which could not have been anticipated at the pleading stage. Although it will of course be appropriate to take account in this circumstance of the already completed course of the litigation, dismissal of the state claim might even then be merited. For example, *it may appear that the plaintiff was well aware of the nature of his proofs and the relative importance of his claims;* recognition of a federal court's wide latitude to decide ancillary questions of state law *does not imply that it must tolerate a litigant's effort to impose upon it what is in effect only a state law case.* Once it appears that a

> state claim constitutes the *real* body of a case, to which the federal claim is only an appendage, the state claim may fairly be dismissed." (Emphasis added)

Two decisions in the Southern District of New York squarely support petitioner's position. Both cases involved mutual funds. A short, cogent opinion by Judge Edelstein carefully discussed and properly applied *United Mine Workers* v. *Gibbs, supra,* and *Cohen* v. *Beneficial Industrial Loan Corp., supra.* In *Mintz* v. *Allen,* 254 F. Supp. 1012, the court held (p. 1014):

> "Both as a matter of law and as a matter of policy the court finds that State security requirement should be enforced (as to state causes of action only) by the federal courts in pendent as well as diversity jurisdiction cases.[2]"

"[1] Judge Weinfeld, relying on Phelps v. Burnam, 327 F. 2d, 812 (2d Cir. 1964) and Fielding v. Allen, 181 F. 2d. 163 (2d. Cir.) cert. denied, Ogden Corp. v. Fielding, 340 U.S. 817, 71 S. Ct. 46, 95 L. Ed. 600 (1950) has reached the same result. Kane v. Central American Mining & Oil, Inc. 235 F. Supp. 559, 567-569 n. 40 (S.D.N.Y. 1964). In both Phelps and Fielding however, jurisdiction over the non-Federal claims was based on diversity. In Kane, the argument urged in instant case was apparently not made."

Judge Bonsal has recently reached the same result in *Entel* v. *Allen* (64 Civ. 4048, S. D. N. Y., January 31, 1967) —— F. Supp. ——, reported in CCH Federal Securities Laws, ¶91, 886, expressly following *Mintz* v. *Allen, supra.*

The S.E.C. Report adds weight to petitioner's contention that only state law applies to reasonableness of advisory fees. It says (p. 139):

> "Plaintiffs' counsel were not unmindful of the likelihood of an adverse judgment, since each fully litigated case had resulted in a judgment for defendants. And under the courts' interpretation of *applicable State*

law, obtaining a favorable result was no easy matter. The most modest of settlements seemed preferable to the risk of a trial which was likely to result in an adverse decision." (emphasis added)

The S.E.C. thus expressly recognized that what is involved in mutual fund litigation concerning advisory fees is "applicable state law."

The Report also stated at page 133:

"In most cases settlements were reached which provided for some reduction in advisory fees to be charged in future years. In only three cases did the termination result from a judgment on the merits based on an evidentiary record developed in an adversary proceeding. Each of the three fully litigated cases (Meiselman v. Eberstadt, decided in May of 1961,[138] Saxe v. Brady, decided in September of 1962,[139] and Acampora v. Birkland, decided in July of 1963)[140] held that the plaintiffs had failed to prove the fees legally excessive and resulted in a judgment for the defendants.[141]"

"[138] 39 Del. Ch. 563, 170 A. 2d 720.
"[139] 40 Del. Ch. 474, 184 A. 2d 602.
"[140] 220 F. Supp. 527 (D. Colo.)."
[141] Footnote omitted.

The *Saxe* v. *Brady* case, cited by the S.E.C., *supra,* contains a lengthy and thorough discussion of Delaware law. The only federal case cited by the S.E.C. applied Delaware law in the Colorado federal court.

Respondent's attorney, who verified the complaint and the amended complaint, is, of course, well aware that state law controls the gist* of this action and is likewise "well aware of the nature of his proofs and the relative im-

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* The present case contrasts with *J. I. Case Co.* v. *Borak,* 377 U.S. 426, where the gist of the complaint was a federally created right.

portance of his claims." *United Mine Workers* v. *Gibbs*, 383 U.S. at 727. At the University of Pennsylvania Law School Conference on Mutual Funds, held less than one month after he verified the complaint, Abraham L. Pomerantz, Esq. was a panel speaker. He is reported as saying (115 Univ. of Penn. L. Rev. 659, 753):

> "MR. POMERANTZ: I have had fourteen investment company cases and fourteen sets of depositions and/or cross-examinations of the independent directors, and in not one single case did any unaffiliated director ever respond 'Yes' to this type of question: When your fund grew from $100 million to $600 million, did you ever give any thought to making a comparison between your half of one per cent fees and somebody else's fees?
> No."

A few pages earlier (p. 740) Mr. Pomerantz had also recognized, in agreement with the S.E.C. Report (quoted *supra*, pp. 15-16), that "every stockholder's action charging excessiveness that has gone to trial has been nonsuited or dismissed * * *." These cases, of course, turned on what the S.E.C. called "applicable state law" (pp. 15-16, *supra*), and state law alone.

That the defense of this state law action will be equally successful is foreshadowed by the facts briefly outlined in the moving affidavit, paragraph 10 (pp. 8a-9a), showing the declining scale of advisory fees instituted when petitioner had barely crossed $10,000,000 in size.

But, in the meantime, petitioner is put to the expense of defending a state equity suit in the federal court, where plaintiffs have demanded a jury (p. 14a), without the protection of New York law where it is incorporated and where the federal forum is.

The mere fact that respondents have "jumbled" three wholly unrelated claims in a single count cannot permit them to escape New York law. In a diversity derivative action in which $100,000 security was upheld, Judge Friendly has said for the Court, *Phelps* v. *Burnham,* 327 F. 2d 812 (2d. Cir.) at p. 814:

> "... It is scarcely persuasive that, as appellant urges, the Complaint might have jumbled the two claims together; this might have made it harder to draw the order but would not have altered the essentials."

The artifice of jumbling state and federal claims in a single count should be no more successful in "pendent jurisdiction" cases than in "diversity" cases.

The "fourteen investment company cases" which respondents' attorney has brought (*supra,* p. 17), all of which must turn upon what the S.E.C. Report calls "applicable State law" (*supra,* p. 16) cannot have failed to inculcate that degree of forum awareness which *Erie R.R. Co.* v. *Tompkins,* 304 U.S. 64, sought to make supportive, rather than destructive, of state policy.

Until this Court at this stage of an action determines the important and unsettled questions presented, its decision in *Cohen* v. *Industrial Loan Corp., supra,* will remain only half effective. Transparently inappropriate federal labels will suffice to defeat state policy, to impose state law cases on federal courts, and to frustrate this Court's decisions.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

Dated: July 11, 1967

Respectfully submitted,

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Notice of Motion for a Protective Order

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 60

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.), JESUP & LAMONT and AMERICAN INVESTORS FUND, INC.,

Defendants.

SIRS:

PLEASE TAKE NOTICE that upon the annexed affidavit of John F. Newton sworn to the 15th day of February 1967, and upon the notice to take deposition upon oral examination of defendant George A. Chestnutt, Jr. dated the 30th day of January 1967 and upon the complaint, copies of which are hereto annexed, and upon all the proceedings heretofore had in this action, defendant American Investors

Notice of Motion for a Protective Order

Fund, Inc. by its undersigned attorneys will move this Court at Room 506, United States Courthouse, Foley Square, Borough of Manhattan, City and State of New York, on the 23rd day of February, 1967, at 10:00 o'clock in the forenoon, or as soon thereafter as counsel may be heard, for a protective order pursuant to Rule 30(b) of the Federal Rules of Civil Procedure conditioning defendant Chestnutt's examination before trial and all further proceedings herein relating to non-federal claims upon plaintiffs first posting $100,000 security for the reasonable expenses including attorneys' fees, which may be incurred by defendant American Investors Fund, Inc. in connection with the above entitled action and by the other parties defendant in connection therewith for which American Investors Fund, Inc. may become subject pursuant to Section 627 of the Business Corporation Law, to which security American Investors Fund, Inc. shall have recourse in such amount as the Court shall determine upon the termination of the action and further requiring plaintiffs to serve a written notice of the giving of said security upon American Investors Fund, Inc.'s attorneys and staying all other proceedings on the part of plaintiffs except to review or vacate said order until compliance with such order, or, in the alternative, dismissing alleged "pendent" state law claims for want of jurisdiction or as a matter of discretion, and for such other, further and different relief as to the Court may seem just and proper.

Notice of Motion for a Protective Order

Dated: New York, N. Y.
February 15, 1967

Yours, etc.

O'Connor & Farber

By /s/ Clendon H. Lee
A Member of the Firm
Attorneys for Defendant
American Investors Fund, Inc.
Office and Post Office Address
120 Broadway
New York, New York 10005
Telephone # RE 2-5800

To:

Pomerantz Levy Haudek & Block, Esqs.
Attorneys for Plaintiffs
Office and Post Office Address
295 Madison Avenue
New York, New York 10017

Carro, Spanbock & Londin, Esqs.
Attorneys for Jesup Lamont
10 East 40th Street
New York, New York 10016

Willkie, Farr, Gallagher,
Walton & Fitzgibbon, Esqs.
Attorneys for Defendant
I.O.S., Ltd. (S.A.), et al.
1 Chase Manhattan Plaza
New York, New York 10005

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 60

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.), JESUP & LAMONT and AMERICAN INVESTORS FUND, INC.,

Defendants.

STATE OF NEW YORK,
COUNTY OF NEW YORK, *ss.:*

JOHN F. NEWTON, being duly sworn, deposes and says:

1. I am Treasurer of defendant American Investors Fund, Inc. ("the Fund"), a New York corporation. Plaintiffs have brought a "derivative" stockholders action against the Fund and the other defendants named in the complaint. This affidavit is submitted in support of the Fund's motion for a protective order conditioning all further proceedings herein including oral examinations before trial upon plain-

tiffs' first posting security for expenses in the initial amount of $100,000 in accordance with §627 of the New York Business Corporation Law, or in the alternative dismissing the state claims.

2. I am advised by the transfer agent of the Fund, The Bank of New York, that the plaintiffs are the record owners of approximately 50 shares of stock in the Fund standing in their names at an address in Brooklyn, New York. The complaint alleges that they bring this action "derivatively on behalf of the Fund." All of the directors of the Fund are named as defendants, including a former director. Other defendants include the investment adviser to the Fund, Chestnutt Corporation (as well as its dissolved predecessor American Investors Corporation), a brokerage firm, and various other defendants including The Fund of Funds, Ltd., which is a substantial shareholder of the Fund.

3. The Fund is a registered investment company under the Investment Company Act of 1940 ("the Act") having assets of approximately 110 million dollars. It has outstanding approximately 3,250,000 shares, each representing an equal interest in the Fund's total assets.

4. I have read the complaint and do not believe there is any merit to this action. The Certificate of Incorporation and By-Laws of the Fund provide in accordance with and subject to the limitations of the Business Corporation Law of New York that the directors, officers and employees of the Fund shall be reimbursed for their expenses, including legal fees, incurred in the defense of derivative shareholders' actions. All directors and a former director are named as defendants. I am advised that counsel will be retained by directors. Consequently, in addition to the

expense the Fund has already incurred, the Fund will immediately incur liability in substantial amounts to reimburse those officers and directors for expenses incurred by them.

5. The first paragraph of the complaint invokes "principles of pendent jurisdiction" and is said to be based "upon common law principles." I am advised by attorneys for the Fund that state law principles, in this case the law of New York where plaintiffs reside and the state of incorporation of the Fund, permeates the entire complaint. I am further advised that the purported federal claims are without merit and of dubious sufficiency. Thus, the only claim stated is in fact a New York claim, upon which a federal label has been attached.

6. The Fund is a "no-load" fund. That is, purchasers of shares pay no commission and acquire their shares at the net asset value per share. Shareholders may redeem at any time at the net asset value, without any payment of any commission or redemption charge. Since there are no salesmen earning commissions which cost the investor some 8% or 9%, the growth of the Fund depends upon its reputation for successful management. As hereinafter appears in detail, the growth by appreciation and by sale of additional sales reduces the advisory fee. Now that the Fund has crossed the $100,000,000 mark, the advisory fee on the asset value over that amount is only four tenths of one percent (0.4 of 1%), which is exactly half the rate of the advisory fee on the first $50,000,000. Thus, the continued growth of the value of the Fund's portfolio and the continued growth by sale of additional shares have the effect

of reducing the overall cost to shareholders of the investment advice furnished by the adviser.

7. The 50-odd shares held by the plaintiff out of the 3,250,000 outstanding have a fair value of no more than approximately $1,800 to $2,000, thus being a minute fraction of 1% of the Fund's outstanding shares and less than $50,000 in fair value. In view of the serious common law allegations in the complaint of violation of fiduciary duty attacking transactions involving millions of dollars, it will be necessary to conduct extensive preparation for trial, extensive discovery proceedings and to engage in a protracted law suit. Consequently, the expense to the Fund will be very heavy. The expense will be immediate, since the oral examination of a director and president of the Fund has already been noticed, even prior to joinder of issue. The expenses, including counsel fees, which the Fund will be required to pay and reimburse will also be heavy and will soon mount to at least $100,000 if the case proceeds as indicated. These heavy expenses are directly related to the "pendent jurisdiction" invoked in the complaint. I am advised that the narrow legal claims under federal labels are very much simpler to defend and litigate and will not require as heavy a financial burden to defend.

8. Since plaintiffs do not hold sufficient shares of the Fund to meet the standards of §627 of the Business Corporation Law, and since the Fund has already incurred expenses and will incur heavy expnse immediately, it is respectfully requested that the Court require the plaintiffs to furnish security in the amount of not less than One Hundred Thoustand Dollars ($100,000) pursuant to §627 of the Business Corporation Law.

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

9. There are, in essence, three things complained of. The first is that the advisory fee is too high and is not related to the services performed by the investment adviser. Counsel have informed me that only three cases have been dcided on the merits out of the many cases which have been brought against mutual funds and their advisers, and all three cases have been determined in favor of the defendants and have applied state law, two of them in Delaware and the other by a federal court in Colorado which applied Delaware law and quoted extensively from the opinion of the Delaware Chancellor.

The second matter complained of asserts that there is domination and control of the Fund, claiming in one breath that a large Swiss stockholder, defendant The Fund of Funds, Ltd., controls the Fund, and claiming contrary-wise in another breath that the Fund is controlled by its adviser, Chestnutt Corporation.

The third purported claim relates to brokerage fees on portfolio transactions. It is not alleged that the Fund engaged in "churning", or was overcharged, or paid any brokerage fees other than the standard, customary and prescribed brokerage fees. Yet it is claimed that payment of brokerage fees constituted "conversion" and a "rebate", and various wrongful and even criminal labels are attached thereto.

10. The records of the Fund show that it commenced the year 1964 with net assets of $11,040,000. At that time this small, no-load Fund was paying a flat 1% per year advisory fee. During that year a new contract was entered into effective June 30, 1964, providing the following advisory fee schedule:

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

Annual Rate	*Total New Asset Value*
0.8 %	First $50 million
0.6 %	Next $50 million
0.4 %	Next $100 million
0.3 %	Next $100 million
0.25%	Next $100 million
0.2 %	Next $100 million
0.15%	Next $500 million
0.10%	Excess of $1,000 million

This contract has been approved periodically by the Fund's shareholders including these individual plaintiffs who voted approval.

Since the Fund now has net assets of $110,000,000, it has now reached the third bracket of 0.4 of one percent, effecting an overall reduction in the cost to shareholders for the fee paid to the adviser.

No doubt the spectacular growth of this no-load Fund, not merchandised by persons seeking the customary 8% or 9% commission and not sold pursuant to "plans" with heavy "front-end loads", is due to the investment record of the Fund. For example in the year 1966, the net asset value per share (assuming re-investment of capital gain distributions) increased 3.0%, while the Dow Jones Industrial Average went down 18.9%. Thus, the investment adviser who is accused of performing services which "bear no relationship to the fees charged therefor," paragraph 5(i), was able in the chaotic markets of 1966 to perform services approximately 22% better than the Dow Jones Industrial Average referred to. Records in my possession show the Fund's increase in value per share from $10 per share in January of 1958 when the Fund made its first

investment to the end of the year, 1966. They show that (assuming re-investment of capital distributions) the value per share has increased 311.2%, whereas the Dow Jones Industrial Average has increased 75.6%. Thus, each shareholder of the Fund during the period has fared approximately 4 times as well as the Dow Jones Industrial Average.

I am advised by counsel that even if the Federal statute should be amended to create for the first time a federal standard of "reasonableness", as contrasted with the state standard, for the fees charged by investment advisers that the Securities and Exchange Commission has recommended that investment results be taken into account. As will be discussed more fully in the brief to be submitted in support of this motion, the Securities and Exchange Commission stated in a recent report to Congress (p. 145):

> "Thus the sustained investment performance of a company would be an appropriate consideration in evaluating the reasonableness of its advisers compensation."

The "sustained investment performance" of American Investors Fund, Inc. is shown by "Exhibit A" hereto, a four page supplement to "Investment Companies 1966" published by Arthur Wisenberger & Co. On the third page appears the fact that for the five-year period, 1962-1966, the appreciation per share of American Investors Fund was 145.3%, by far the best of all the funds listed.

Thus, even if Congress should create a federal body of law which for the first time would govern the fees paid to investment advisers, it is clear that the record of results would permit this no-load fund to continue the payment

of fees in accordance with the decreasing scale which the Fund has been paying.

Nevertheless, and without regard to the certainty of ultimate vindication in equity, in morals and at law, the defense of this action will require extensive and protracted preparation to meet charges of violation of state law. This will be very expensive to the Fund and to its directors whom the Fund is required to reimburse. I do not believe there is any relationship between this state claim and the other allegations in the complaint.

11. The second claim in the complaint, in the segment of allegations contained in paragraphs 6 through 11, does not relate in any way to the first claim that the advisory fee is unreasonable under state law. This second claim apparently seeks declaratory relief upon the bare assertion that a Swiss-based mutual fund dominates and controls the Fund. I am advised by counsel that even if the second claim were to be held to be sufficient under federal law, that nothing relating to the first claim would be relevant or material to prove this second claim. Since this motion is not directed to the sufficiency of the federal claims set forth in the second and third segments of the complaint, I simply want to deny plaintiffs' completely unfounded assertions.

I have inquired of other officers and directors of the Fund and its investment adviser and I am informed that at no time has there been any attempt made by The Fund of Funds to dominate or control the management or policy of the Fund. Only one new director, defendant Warren K. Greene, has joined the board of directors of the Fund since The Fund of Funds made its first purchase of shares in 1964. Mr. Greene was employed by the Fund's investment

adviser in January 1965, and he became a director of the Fund in 1966. From 1959 to 1965 Mr. Greene was employed by First Boston Corporation. He has advised me that he has had no connection or dealings whatever with The Fund of Funds or with any of its affiliates. The tenure of the other board members antedates by several years the first purchase of shares in American Investors Fund by The Fund of Funds.

The Fund's Certificate of Incorporation from its inception, some five years before The Fund of Funds commenced buying shares of the defendants' stock, has provided that if the Board of Directors determined that it was in the best interests of the remaining shareholders of American Investors Fund, it may pay a redemption in whole or in part in kind by distribution of securities from its portfolio. Thus, even if it were to be assumed that a substantial and concentrated shareholding could possibly influence the Fund by massive redemption or threatened massive redemption, the Fund is in a position where it may disregard any conceivable threatened influence with complete impunity and without the slightest risk, market or otherwise, to its remaining shareholders.

Moreover, The Fund of Funds has advised American Investors Fund that in keeping with its policy of not investing in any fund for the purpose of obtaining and exercising control that it has adopted a policy of voting shares in the same proportion that other shares are voted on particular issues, except 3%, which it reserves the right to vote in such manner as The Fund of Funds sees fit.

I do not know of any facts relevant or material to the first state law claim which have any bearing upon the asserted claim under federal law that the Fund is dominated by a foreign shareholder.

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

12. The third claim asserts violations of federal law, with respect to brokerage commissions (paragraphs 12 through 20).

I do not understand how this claim involves the Fund, since the allegations relate to supposed relationships between The Fund of Funds and a brokerage firm.

Irrespective of what the facts may be, it is clear that the reasonableness of the advisory fee under state law does not involve the same facts as the relationships between The Fund of Funds and a brokerage firm.

13. In conclusion, it is clear to me as principal financial officer of the Fund that there will be an immense amount of work to do to prepare the defense of the alleged state claim. I know of no factual connection between the state claim and the two federal claims relating to foreign domination and brokerage. For the reasons set forth herein, I respectfully submit that the plaintiffs should be required to furnish security in the amount of $100,000, or in the alternative that the state claim be dismissed.

/s/ JOHN F. NEWTON
John F. Newton

Sworn to before me this 15th day of February 1967.

/s/ EDNA M. MILBERY
Notary Public

EDNA M. MILBERY
Notary Public, State of New York
No. 24-7982800
Certified in Kings County
Cert. filed with New York County
Term Expires March 30, 1968

Complaint

(Original)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 60

PLAINTIFFS DEMAND TRIAL BY JURY

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.), JESUP & LAMONT and AMERICAN INVESTORS FUND, INC.,

Defendants.

Plaintiffs, by their attorneys, Pomerantz Levy Haudek & Block, for their complaint, allege upon information and belief, except paragraph "2", which is alleged upon knowledge:

1. This action arises under the Investment Company Act of 1940, 15 U.S.C. §§ 80 a-1, et seq. (the "Act") and common law principles. The jurisdiction of the court is based on the Act and on the principles of pendent jurisdiction.

2. (a) Plaintiffs jointly are shareholders of defendant, American Investors Fund, Inc. (the "Fund") and have been shareholders since at least 1963 and at the times of the wrongs complained of herein.

(b) Plaintiffs bring this action derivatively on behalf of the Fund and representatively on behalf of themselves and all other shareholders of the Fund similarly situated.

(c) This action is not brought collusively to confer upon this court jurisdiction which it otherwise would not have.

3. The Fund is a New York corporation. It is and at all times relevant herein has been registered under the Act as a diversified open end management investment company.

4. (a) The individual defendants, other than Elizabeth Sullivan, comprise the Fund's board of directors. Elizabeth Sullivan has been a director of the Fund during the times of the wrongs complained of herein.

(b) In addition to their being directors of the Fund, defendant, George A. Chestnutt, Jr., is president of the Fund, defendant, Stanley L. Sabel, is vice-president and secretary of the Fund, and Elizabeth Sullivan has been, during the times of the wrongs complained of, treasurer of the Fund, and is presently assistant-treasurer of the Fund.

5. (a) Defendant, Chestnutt Corporation, a Connecticut corporation, is the successor in interest to American Investors Corporation, the investment adviser of the Fund. Defendant, George A. Chestnutt, Jr., is president, Treasurer and a director of Chestnutt Corporation and American Investors Corporation, and owns about forty-six (46%)

percent of the voting stock of each corporation. Defendant, Stanley L. Sabel, is vice-president, secretary and a director of Chestnutt Corporation and American Investors Corporation, and owns about sixteen (16%) percent of the voting stock of each. Defendant, John Currier, owns about two (2%) percent of the voting stock of Chestnutt Corporation and American Investors Corporation. Defendant, Elizabeth Sullivan, is assistant to the president of Chestnutt Corporation and American Investors Corporation.

(b) The Fund pays to Chestnutt Corporation, and has paid to American Investors Corporation, pursuant to investment advisory contracts, an annual advisory fee equal to .8% of the first $50,000,000 of net assets of the Fund; .6% on the next $50,000,000; .4% on the next $100,000,000; .3% on the next $100,000,000; .25% on the next $100,000,000; .2% on the next $100,000,000; .15% on the next $500,000,000, and .10% on all net assets in excess of $1,000,000,000.

(c) For the years ending December 31, 1963, 1964 and 1965, and the first six months of 1966, the Fund paid to American Investors Corporation investment advisory fees of $93,347.00, $187,083.00, $337,626.00 and $248,443.00, respectively.

(d) The huge increase in the amounts of the invesment advisory fee since 1963 has been due to the sharp rise in the net assets of the Fund. This rise has been due in large part to the sale of additional Fund shares to the public, which has provided substantially no benefits to the Fund and its shareholders. Despite the sharp rise in the amounts of the investment advisory fees, the expenses incurred by American Investors Corporation and Chestnutt Corporation in rendering investment advice and performing its

other management duties have remained substantially the same.

(e) Other managers and investment advisers did and do perform similar and more extensive duties for other investment companies at rates substantially below those charged by American Investors Corporation and Chestnutt Corporation to the Fund.

(f) The investment advisory fee paid by the Fund is one of the highest percentage fees paid by any open end investment company of which public information is available.

(g) The ratio of total operating expenses of the Fund to its average net assets (its "expense ratio") was approximately 1.2% in 1965, and was of similar magnitude in earlier years. It is grossly excessive and is one of the highest incurred by any investment company. It is far larger than the expense ratio of investment companies of comparable size to the Fund.

(h) In 1965 the operating expenses of the Fund consumed about sixty-six (66%) percent of the investment income of the Fund.

(i) The services performed by American Investors Corporation and Chestnutt Corporation for the Fund bear no relationship to the fees charged therefor.

6. (a) Defendant, The Fund of Funds, Ltd., a Canadian corporation, owns approximately thirty-six (36%) percent of the capital stock of the Fund.

(b) Defendant, The Fund of Funds, Ltd., is controlled by defendant, I.O.S., Ltd. (S.A.) ("IOS"), a Panama corporation, by reason of ownership by IOS of all of The Fund of Funds, Ltd.'s voting stock.

7. Defendants, John Currier, Frank G. Fowler, Jr., Warren K. Greene, Richard W. Radcliffe and Francis L. Veeder, obtained their positions with the Fund through the influence and action of defendants, Chestnutt, Sabel, American Investors Corporation, Chestnutt Corporation, The Fund of Funds, Ltd. and IOS and are beholden thereto for the substantial emoluments derived from their positions.

8. Chestnutt Corporation and American Investors Corporation are able to, and do, dominate and control the Fund and its personnel, its policies and its board of directors. By reason of such domination and control, § 10 (a) of the Act has been and continues to be violated.

9. By reason of the aforesaid domination and control the investment advisory contracts are and have been illegal and void and in violation of § 15 of the Act, and the payment of investment advisory fees thereunder is and has been illegal. Such shareholder approval of the investment advisory contracts as have been obtained has been procured through concealment of the aforesaid domination and control in violation of § 20 of the Act and is therefore void and of no effect.

10. The investment advisory fees paid by the Fund to American Investors Corporation and Chestnutt Corporation are excessive and constitute waste and spoliation of the Fund's assets in violation of the Act.

11. By reason of the aforesaid violations of the Act, the investment advisory fees paid by the Fund to American Investors Corporation and Chestnutt Corporation have been and are illegal.

12. The Fund of Funds, Ltd. and IOS are able to, and do, dominate and control the Fund and its personnel, its policies and its board of directors, with respect to the allocation of the Fund's brokerage.

13. As a result of the domination and control of the Fund by IOS, brokerage orders of the Fund have been and are placed at the request of IOS with the defendant, Jesup & Lamont, a New York partnership engaged in the securities business.

14. The basis for allocation of brokerage business to Jesup & Lamont was and is directly related to the size of the investment of The Fund of Funds, Ltd., in the Fund.

15. Commissions paid to Jesup & Lamont by the Fund were $111,142.00 in 1964 and $137,692.00 in 1965, and $29,184.00 in the first six months of 1966.

16. IOS and affiliated and related persons and organizations of IOS have derived substantial benefits from the Fund brokerage directed by IOS to Jesup & Lamont.

17. The aforesaid benefits include the following:

(i) Jesup & Lamont has furnished to IOS research, investment advisory and investment banking services, and Schroeder Boulton, a partner of Jesup & Lamont, has agreed to and has become a member of the board of directors of The York Fund, Inc., a registered investment company all the stock of which is owned by The Fund of Funds, Ltd. and the management company of which is controlled by IOS.

(ii) Mrs. Gloria Martica Clapp, the registered representative employee of Jesup & Lamont who is credited

by that firm with all commissions received by or given-up to the firm as a result of the designations made by IOS, has arranged for the deposit with Fiduciary Trust Company, Ltd., Nassau, the Bahamas (Fiduciary), of most of the amounts paid to her by Jesup & Lamont, as her share of the brokerage commissions on all business directed to it or give-ups paid to it at the request of IOS. Fiduciary, in turn, has transferred substantial sums of money to banks controlled by IOS or to banks which have material banking relationships with IOS.

(iii) Mrs. Clapp and her husband, Samuel F. Clapp, directly and indirectly through J. H. Crang & Co. (Nassau) Ltd., have assisted IOS in obtaining work entry permits for its salesmen, to permit them to sell the IOS Investment Program in Nassau, the Bahamas.

(iv) Samuel F. Clapp, directly and indirectly through Fiduciary and J. H. Crang & Co. (Nassau) Ltd., assisted in the procurement for IOS of subscribers to its IIT investment advisory service, "International Economic and Market Reports," at a subscription price of $2,500 per month ($30,000 per year) per subscription. These subscribers have paid to IOS substantially in excess of $100,000.

(v) Samuel F. Clapp has arranged for financial institutions to deposit more than $7,000,000 with banking institutions controlled by IOS or in which IOS has an interest.

(vi) Samuel F. Clapp, a member of the Bar of Massachusetts, directly and indirectly through Fiduciary, has provided IOS and its affiliated companies and persons with legal advice and a variety of other valuable services relating to the business affairs of IOS.

(vii) Samuel F. Clapp has introduced IOS, and caused IOS to be introduced, to persons with whom IOS or various of its subsidiaries have enjoyed valuable relationships.

18. As a result of such direction of brokerage, the Fund has been deprived of substantial benefits which otherwise would accrue to it.

19. The direction of brokerage commissions to Jesup & Lamont, as above-described, has constituted and continues to constitute a rebate to The Fund of Funds, Ltd., through its affiliate IOS, from the current public offering price of Fund shares in violation of § 22 of the Act.

20. The payment of such brokerage commissions to Jesup & Lamont has constituted and continues to constitute an unlawful and willful conversion by The Fund of Funds, Ltd., IOS, Jesup & Lamont and the individual director defendants of the monies, funds, property and assets of the Fund to the use of The Fund of Funds, Ltd., IOS and Jesup & Lamont, in violation of § 37 of the Act; and gross abuse of trust, gross misconduct, willful misfeasance, bad faith, gross negligence and a reckless disregard of their fiduciary duties by the Fund's officers and directors in violation of the duties which §§ 10, 17(h) and 36 of the Act impose upon them; and constitutes a waste and spoliation of the Fund's assets for the benefit and profit of IOS, The Fund of Funds, Ltd. and Jesup & Lamont, but to the harm and detriment of the Fund.

21. Demand upon the Fund's board of directors to bring this action would be futile and is unnecessary for at least the following reasons:

(a) The directors are defendants herein and participated or acquiesced in the wrongs alleged and are liable therefor;

(b) Defendants, American Investors Corporation, IOS and The Fund of Funds, Ltd., control and dominate the Fund and its board of directors; and

(c) The institution of the action by the Fund's directors would place it in hostile hands and would prevent its effective prosecution.

22. Demand upon the Fund's shareholders to bring this action would be futile and is unnecessary for at least the following reasons:

(a) The wrongdoings alleged herein violate the Act and are a waste of the Fund's assets and hence are incapable of shareholder ratification.

(b) Under New York law and under the charter and by-laws of the Fund, the management of its affairs, including the bringing of suits, is entrusted to the board of directors, not to the shareholders. The shareholders cannot by resolution or otherwise require the Fund or its board of directors to bring an action.

(c) Even if the shareholders were to direct the board of directors to bring this action, its control would lie in the hostile hands of the directors, who could not be entrusted with its effective prosecution.

(d) The Fund has many thousands of shareholders scattered all over the United States and foreign countries. Their identity is subject to frequent changes. To secure action from the shareholders would require a proxy fight with the management, which controls the proxy machinery of the Fund, and uses the Fund's moneys in preparing and mailing proxy material and soliciting the shareholders' votes. The conduct of a proxy fight by plaintiff would entail prohibitive expenses and would cause undue loss of time, with the danger that the claims alleged might become barred by the Statute of Limitations or laches.

WHEREFORE, plaintiffs pray for judgment:

(a) Declaring the contract employing Chestnutt Corporation as investment adviser of the Fund to be void;

(b) Enjoining defendants, temporarily and permanently, from continuing their unlawful conduct alleged herein;

(c) Requiring defendants other than the Fund to account for and pay to the Fund the advisory fees received by them since 1963;

(d) Requiring defendants other than the Fund to account for and pay to the Fund the brokerage commissions paid to Jesup & Lamont since 1963;

(e) Requiring the defendants other than the Fund jointly and severally to account for and pay to the Fund for their profits and gains and its losses;

(f) Awarding the plaintiffs the costs and expenses of this action including reasonable counsel fees; and

(g) Granting plaintiffs such other and further relief as may be just.

POMERANTZ LEVY HAUDEK & BLOCK

by /s/ ABRAHAM L. POMERANTZ
Member of Firm
Attorneys for Plaintiffs
Office & P. O. Address
295 Madison Avenue
Borough of Manhattan
City of New York 10017

STATE OF NEW YORK,
COUNTY OF NEW YORK, *ss.:*

ABRAHAM L. POMERANTZ, being duly sworn, deposes and says that he is a member of the firm of POMERANTZ LEVY HAUDEK & BLOCK, the attorneys for plaintiffs herein and has his office at 295 Madison Avenue, in the City of New York, County of New York; that he has read the foregoing complaint and knows the contents thereof and that the same is true of his own knowledge except as to matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true; that the reason why this verification is made by deponent instead of by plaintiffs is because plaintiffs are not within the County of New York, which is the county where deponent has his office. Deponent further says that the grounds of his belief as to all matters in said complaint not stated upon his knowledge are based upon his general investigation of the facts of this case.

/s/ ABRAHAM L. POMERANTZ
ABRAHAM L. POMERANTZ

Sworn to before me this
6th day of January, 1967.

DONNAGENE BURFIELD
Notary Public, State of New York
No. 24-5523665
Qualified in Kings County
Certificate filed in New York County
Commission Expires March 30, 1968

Amended Complaint

(First paragraph only, remanider of amended complaint identical to original complaint)

1. This action arises under the Investment Company Act of 1940, 15 U.S.C. §§ 80 a-1, et seq. (the "Act"). The jurisdiction of the court is based on the Act.

Memorandum Decision and Order of District Court

Rosalind Fogel and Gerald Fogel v. *George A. Chestnutt, Jr., et al.*, 67 Civ. 60, Civ. Mot. Cal. March 2, 1967 No. 51

Whether or not the amended complaint states a federal claim must, of course be determined on the face of the pleading, without regard to whether its allegations are true.

Brown v. *Bullock*, 294 F.2d 415 (2d Cir. 1961)

In my opinion, the allegations of the amended complaint with respect to the claimed illegality of the investment advisory contracts and the fees paid thereunder, contracts which are alleged to have been made as a result of the domination and control of the fund and its directors by the investment advisor, are sufficient to state a claim for violation of the Investment Company Act within the rule laid down in *Brown* v. *Bullock, supra.* It may be noted that since that case was decided in 1961, there has been a growing trend in favor of upholding federal jurisdiction in securities cases over claims which arguably could have been thought to charge merely a violation of state law. See *Brod* v. *Perlow*, Docket No. 31028 (2d Cir. March 27, 1967) which

involved Section 10(b) of the Securities Exchange Act of 1934.

Since the other claims alleged in the amended complaint are concededly federal, defendant is not entitled to a bond.

Fielding v. *Allen*, 181 F.2d 163 (2d Cir. 1950), *cert. denied*, 340 U.S. 817 (1950)

It also follows that the claims based upon the alleged illegality of the investment advisory contracts and the advisory fees should not be dismissed.

Motion denied.

So ordered.

Dated: March 30, 1967

EDWARD C. McLEAN
U. S. D. J.

Order of Affirmance of Court of Appeals

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the eighth day of May, one thousand nine hundred and sixty-seven.

Present:

HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,
Circuit Judges.

ROSALIND FOGEL and GERALD FOGEL,
Plaintiffs-Appellees,

—v.—

GEORGE A. CHESTNUTT, JR., *et al.*,
Defendants-Appellants.

A motion having been made herein by counsel for the appellees to dismiss the appeal for lack of jurisdiction or to summarily affirm the order of the District Court,

Upon consideration thereof, it is

Order of Affirmance of Court of Appeals

Ordered that said motion to dismiss be and it hereby is denied.

Further ordered that the order of the United States District Court for the Southern District of New York be and it hereby is affirmed with costs to the appellees.

A. DANIEL FUSARO
Clerk

SUPREME COURT, U. S.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 366

AMERICAN INVESTORS FUND, INC.,

Petitioner,

v.

ROSALIND FOGEL and GERALD FOGEL,

Respondents,

and

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.) and JESUP & LAMONT,

Defendants.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF PETITIONER FOR LEAVE TO FILE PETITION FOR REHEARING AND PETITION FOR REHEARING

CLENDON. H. LEE,
Counsel for Petitioner,
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Of Counsel:
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120 Broadway,
New York, N. Y. 10005.

TABLE OF CONTENTS

	PAGE
Motion of Petitioner for Leave to File a Petition for Rehearing	1
Petition for Rehearing	3
Conclusion	7
Certificate of Counsel	8

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 366

AMERICAN INVESTORS FUND, INC.,

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Defendants.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF PETITIONER FOR LEAVE TO FILE A PETITION FOR REHEARING

Petitioner, by its counsel, moves this Court to grant leave to file a petition for rehearing of denial by this Court of a petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

The accompanying petition sets out an intervening circumstance of substantial and persuasive importance for granting the petition for rehearing and for a writ of certiorari.

The petition for a writ of certiorari was denied on October 9, 1967. Subsequent to that time this Court granted certiorari in No. 486, *Stern* v. *South Chester Tube Company.*

Jurisdiction of this Court to grant petitions for rehearing which were filed after the expiration of the time prescribed by the Rules of this Court is recognized in *United States* v. *The Ohio Power Co.*, 353 U. S. 98, which case also recognized the considerations which move this Court in the exercise of its discretion to grant petitions for rehearing filed after the time within which they may be filed as a matter of right under Rule 58 of this Court.

That the exercise by this Court of its jurisdiction would be proper is also recognized by *Bradley Mining Co.* v. *Boice*, 345 U. S. 932; *Land* v. *Dollar*, 330 U. S. 731; *United States* v. *General Motors*, 323 U. S. 373; and *Cohen* v. *Beneficial Industrial Loan Corporation*, 337 U. S. 541.

We submit that the accompanying petition for rehearing should be accepted for filing and granted.

Respectfully submitted,

CLENDON H. LEE,
Counsel for Petitioners.

January 1968.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 366

AMERICAN INVESTORS FUND, INC.,
Petitioner,

v.

ROSALIND FOGEL and GERALD FOGEL,
Respondents,

and

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Defendants.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR REHEARING

The intervening circumstance of substantial importance relied upon by petitioner is the grant of certiorari in No. 486, *Stern* v. *South Chester Tube Company,* (3 Cir.) 378

F. 2d 205. Petitioner believes that the granting of such petition provides a substantial and persuasive ground for the granting of this petition for rehearing and for issuance of the writ of certiorari herein, and that this case should be set down for hearing on the merits together with the hearing on the merits of No. 486.

The common demoninator of this case (No. 366) and the *Stern* case (No. 486) is whether mere nomenclature can in the federal court defeat substantive rights under state corporation law.

In this case (No. 366) petitioner has an absolute right in this derivative stockholders' action to security for expenses with respect to state law claims, N. Y. Bus. Corp. Law, Sec. 627 (9 McKinney's Cons. L. of N. Y., Sec. 627), *Cohen* v. *Beneficial Industrial Loan Corporation,* 337 U. S. 541.

In the *Stern* case (No. 486) there is an absolute state right in substantive law to examine corporate records. 15 Purdon's Statutes, Sec. 2852-308.

In this case (No. 366), an initial label of "pendent jurisdiction" has been sufficient to defeat petitioner's absolute state right to security with respect to the state claim, even though additional purported federal claims cannot "derive from a common nucleus of operative fact" with the state claim which is the real gist of the action. *United Mine Workers* v. *Gibbs,* 383 U. S. 715, 725.

In the *Stern* case (No. 486) a divided court below held that the label in the substantive statute, couched in the vestigial parlance of mandamus, ousted the district court of jurisdiction.

Thus, both cases squarely raise "outcome-determinative" issues in the application of the Rules of Decision Act, 28 U.S.C. 1652, and squarely raise the issue how far *Erie R.R. Co.* v. *Tompkins,* 304 U. S. 64, may be eroded by

lower courts, the result of which erosion is to determine the outcome of a substantive state issue precisely the opposite in the federal court from its necessary determination in the state court.

The nine itemized subdivisions of paragraph "5"* of the complaint herein (requiring two full pages of print at pp. 15a-17a of the appendix to our petition) purport to allege only a New York common law claim of violation by directors of fiduciary obligation with respect to the investment advisory fee paid.

The Securities and Exchange Commission has itself explicitly recognized that actions with respect to advisory fees paid by investment companies are governed solely by "applicable state law" (see petition, pp. 15-16).**

All that follows paragraph "5"* in the complaint relates to wholly different operative facts which respondents allege give rise to federal claims. Even, however, assuming the sufficiency of the following federal claims, our petition shows that there is no "common nucleus of operative fact" as required by *United Mine Workers* v. *Gibbs, supra,* between and among the state claim in paragraph "5"* and the purported federal claims. Consequently, at the very least, petitioner is entitled to security with respect to the state law claim.

The first paragraph of the original complaint invokes both "common law principles" and "pendent jurisdiction." This single paragraph was amended during the pendency of the motion for security, leaving the remainder of the

---

* The state claim is parroted in paragraph "10".

** Since American Investors Fund, Inc. is a "no-load fund," with no sales or redemption charges, with a sustained investment performance record among the best in the world, it is merely a bystander in the current legislative hearings with respect to creating federal jurisdiction over "front-end loads", sales charges, etc.

complaint wholly unaltered (pp. 14a, 25a). See particularly, Lowenfels, *Pendent Jurisdiction and the Federal Securities Acts,* 67 Col. L. Rev. 474 (March 1967).

The necessity of giving prompt and effective recognition of substantive state law was the very reason for holding the decision appealable in *Cohen* v. *Beneficial Industrial Loan Corporation; supra,* because, in speaking of "final disposition on the merits," this Court stated (p. 456):

> "When that time comes, it will be too late effectively to review the present order and the rights conferred by the statute, if it is applicable, will have been lost, probably irreparably."

New York courts have expressly recognized that the substantive right to expenses in derivative actions can be obtained only through security previously furnished, and in no other manner. Thus, it was held in *Amdur* v. *Meyer,* 22 A.D. 2d 655 (1964):

> "In the circumstances of this case the corporation may not recover costs pursuant to Section 627 of the Business Corporation Law—*no security for costs having been given.*" (Emphasis added.)

The denial of security by the district court herein irreparably deprives the petitioner of a substantive state right in the same manner that petitioner in No. 486 has been deprived of a substantive state right. In both cases, the deprivation which alters the outcome has been accomplished under mere labels, contrary to the Rules of Decision Act, *supra, Erie R.R.* v. *Tompkins, supra,* and *Cohen* v. *Beneficial Industrial Loan Corporation, supra.*

CONCLUSION

In the light of the intervening action by this Court in granting certiorari in No. 486, it is respectfully submitted that this petition for rehearing and the petition for a writ of certiorari should be granted and that this case should be set down for hearing on the merits at the same time as the argument in No. 486.

Respectfully submitted,

CLENDON H. LEE,
Counsel for Petitioners.

Of Counsel:
O'CONNOR & FARBER,
120 Broadway,
New York, N. Y. 10005.

Certificate of Counsel

I hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay and is restricted to the grounds specified in Rule 58 of the Rules of this Court.

CLENDON H. LEE,
Counsel for Petitioner.

SUPREME COURT, U. S.

JUL 14 1967

JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1967.

No. 366

AMERICAN INVESTORS FUND, INC.,

Petitioner,

v.

ROSALIND FOGEL and GERALD FOGEL,

Respondents,

and

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.) and JESUP & LAMONT,

Defendants.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

CLENDON H. LEE,
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TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	5
Reasons for Granting the Writ	10
Conclusion	19

TABLE OF AUTHORITIES

Cases:

J. I. Case Co. v. Borak, 377 U.S. 426 16

Cohen v. Beneficial Industrial Loan Corporation, 337 U.S. 541 ..... 2, 10, 15, 18

Entel v. Allen (64 Civ. 4048, S.D.N.Y., January 31, 1967) —— F. Supp. ——, reported CCH Federal Securities Laws, ¶91,886 15

Erie R.R. Co. v. Tompkins, 304 U.S. 64 18

Mintz v. Allen, 254 F. Supp. 1012 15

Phelps v. Burnham, 327 F. 2d 812 (2d. Cir.) 18

Saxe v. Brady, 40 Del. Ch. 474, 184 A. 2d 602 16

United Mine Workers v. Gibbs, 383 U.S. 715 ..... 12, 13, 14, 15, 17

PAGE

Other Authorities:

Business Corporations Law of New York, Section 627 (9 McKinney's Cons. L. of N.Y. Sec. 627) 1, 3, 9, 10, 12

The Rules of Decision Act, 28 U.S.C. 1652 4

Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1, et seq.) 4, 5, 6, 7, 8, 11, 13

S.E.C. Report to Congress of December 2, 1966 ("Public Policy Implications of Investment Company Growth", 89th Congress, 2d Session, Union Calendar No. 1046, House Report No. 2337) 9, 15, 16, 17, 18

115 Univ. of Penn. L. Rev. 659, 740, 753 17

Rule 8, F.R.C.P. 13

Rule 30(b), F.R.C.P. 5

INDEX TO APPENDIX

	PAGE
Notice of Motion	1a
Affidavit of John F. Newton (Sworn to February, 15 1967 in Support of Motion)	4a
Complaint (Original)	14a
Amended Complaint (First paragraph only, remainder being identical to original complaint)	25a
Memorandum Decision and Order of District Court	25a
Order of Affirmance of Court of Appeals	27a

IN THE

Supreme Court of the United States

October Term, 1967.

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Defendants.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner American Investors Fund, Inc. prays that a Writ of Certiorari be issued to review the decision of the United States Court of Appeals for the Second Circuit which summarily affirmed the decision of the District Court which had denied petitioner's motion in a stockholders derivative action for security for reasonable expenses, including legal expenses, under Section 627 of the

Business Corporations Law of New York, for an allegedly "pendent" state claim, or, in the alternative, to dismiss the state claim as not being properly "pendent" to purported federal claims.

Opinions Below

The decision of the Court of Appeals was rendered May 8, 1967. It is unreported and is printed at App. p. 27a*. The memorandum decision and order of the District Court was filed March 30, 1967. It is unreported and is printed at pp. 25a-26a.

Jurisdiction

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and 28 U.S.C. 2101(c). Jurisdiction is further invoked under this Court's decision in *Cohen* v. *Beneficial Industrial Loan Corporation*, 337 U.S. 541.

Questions Presented

The first question presented is whether in a stockholder's derivative action plaintiffs are required in accordance with state law to post security for reasonable expenses, including legal expenses, in "pendent jurisdiction" cases, as well as in "diversity" cases as required by *Cohen* v. *Beneficial Industrial Loan Corporation*, 337 U.S. 541.

The second question, in the alternative, is whether the state claim should have been dismissed as not deriving from a common nucleus of operative fact with the purported federal claims.

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* Pages of appendix, bound with this petition, are designated by letter "a".

The third question presented is whether the Court of Appeals properly affirmed summarily on motion the decision of the District Court, without full briefs and the record of the District Court before it, denying petitioner's motion for the relief in the first two questions.

Statutes Involved

Section 627 of the Business Corporations Law of New York (9 McKinney's Cons. L. of N.Y. Sec. 627) provides:

> "§627. Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor
>
> "In any action specified in section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), if the plaintiff or plaintiffs hold less than five percent of any class of the outstanding shares or hold voting trust certificates or a beneficial interest in shares representing less than five percent of any class of such shares, then unless the shares, voting trust certificates and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable under this chapter, under any contract or otherwise under law, to which the corporation shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon

showing that the security provided has or may become inadequate or excessive. L.1961, c. 855; amended L.1962, c. 834, Sec. 43, both eff. Sept. 1, 1963."

The Rules of Decision Act, 28 U.S.C. 1652, provides:

"§1652. The laws of the several states, except where the Constitution or treaties of the United States, or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

Section 10(d) of the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1, et seq.), provides:

"(d) Notwithstanding subsections (a) and (b)(2) of this section, a registered investment company may have a board of directors all the members of which, except one, are affiliated persons of the investment adviser of such company, or are officers or employees of such company, if—

"(1) such investment company is an open-end company;

"(2) such investment adviser is registered under subchapter II of this chapter and such investment adviser is engaged principally in the business of rendering investment supervisory services as defined in said subchapter II;

"(3) no sales load is charged on securities issued by such investment company;

"(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

"(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

"(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

"(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

"(8) such investment company has only one class of stock outstanding, each share of which has equal voting rights with every other share."

Statement

This petition seeks review of an order of the Court of Appeals which summarily affirmed the memorandum decision and order of the District Court denying petitioner's motion for a protective order under Rule 30(b) of the Federal Rules of Civil Procedure, or in the alternative, to dismiss the "pendent" state claims. The protective order sought to compel plaintiffs to furnish a bond in the amount of $100,000 under New York law as security for expenses and legal fees in this shareholders derivative action, or in the alternative to dismiss the state claim.

Petitioner is a New York corporation and is a "no-load" mutual fund (pp. 4a, 6a).

It is a registered investment company under the Investment Company Act of 1940 (the "Act"), and there is no allegation in the complaint that it fails to meet each and every requirement in the eight numbered subparagraphs of Section 10(d) of the Act (quoted *supra*, pp. 4-5).

Among these requirements is that of Subsection 10(d)(6) that any management or advisory fee charged shall not exceed one percent per year, as defined.

The complaint in paragraph "5(b)" correctly alleges that petitioner has paid investment advisory fees annually of 8/10ths of one percent on the first $50,000,000 of net assets, 6/10ths of one percent on the next $50,000,000, and 4/10ths of one percent on the next $100,000,000 (p. 16a). The record shows that at the time of the motion petitioner's net assets were approximately $110,000,000 (p. 9a).

Notwithstanding the fact that petitioner has always met the requirements of the eight numbered subparagraphs of Section 10(d) of the Act, petitioner has also complied with the provisions of Section 10(a) of the Act, which provides that not more than 60 percent of petitioner's directors may be "affiliated persons," as defined in the Act, instead of having only one non-affiliated director which is permitted to an investment company not charging more than a one percent advisory fee. Thus, it is doubly certain that the rate of advisory fee paid by petitioner is legal under the Act, since there is no limitation on such advisory fee where no more than 60 percent of the directors are affiliated, and, in any event, petitioner has paid less than the one percent fee which it could have paid had there been only one unaffiliated director.

There are no allegations in the complaint that petitioner does not have the proper number or percentage of unaffiliated directors. "Affiliation" is not mentioned. Hence, as a matter of federal law, the rate of the advisory fee is not justiciable under the complaint.

Plaintiff's original complaint, which was amended during the pendency of the motion, alleged in paragraph "1" (p. 14a):

> "1. This action arises under the Investment Company Act of 1940, 15 U.S.C. Sec. 80 a-1, et seq. (the "Act") and common law principles. The jurisdiction of the court is based on the Act and on the principles of pendent jurisdiction."

Plaintiffs, therefore, clearly realized that their complaint was based on state law. There are no allegations of diversity of citizenship.

As is set forth below under "Reasons for Granting the Writ," petitioner contends that the only real thrust of the complaint is an action for violation by directors of fiduciary obligation under New York law. Petitioner further contends that the invocation of the Investment Company Act of 1940 is insubstantial at best, and in any event relates only to a portion of the complaint.

Following the making of the motion for security for expenses and legal fees under New York law, plaintiffs filed an amended complaint, amending only Paragraph "1" of the complaint quoted above, so as to delete the reference to "pendent jurisdiction" and "common law principles." (p. 25a)

Thus, the substance of the complaint remains the same after the amendment as it was before.

There are three entirely separate claims in the complaint, and the three claims are totally unrelated in law or in fact. After identification of the parties and an allegation of stock ownership in the first four paragraphs, paragraph "5", containing nine sub-paragraphs, attempts to set forth an action for violation of fiduciary duty under New York law.

A totally different claim is alleged in paragraphs "6" through "11". There the plaintiffs seek to allege that petitioner's agreements with its investment adviser are illegal

and void because the directors of petitioner are said to be under the domination and control of the investment advisers and the stockholders were not informed. The plaintiffs say that this constitutes a violation of Section 10(a) and Section 15 of the Act. There are no grounds or facts set forth to show such domination.

The third segment of the complaint, a third claim, alleges that payments by petitioner of brokerage fees to a brokerage firm were improper, although there is no claim that the brokerage paid was other than the customary brokerage, and there is no claim that it was unnecessary, or that petitioner engaged in "churning" its portfolio (paragraphs "12" through "20").

The state law claim culminating in the allegations of paragraph "5" is nothing more than New York boiler plate allegations of waste in violation of fiduciary duty. The second and third claims purport, in conclusory language, to state that the federal statute had been violated. However, there is no allegation in the second claim (paragraphs "6" through "11") that the directors of petitioner were not chosen in accordance with the Act, or that there were not the requisite number of unaffiliated directors. The third claim cannot really be said to allege any damage to petitioner, since there is no allegation of unnecessary brokerage payments, nor is there any allegation that petitioner paid excessive brokerage commissions.

Thus, the only claim in the complaint which alleges damage to petitioner, and for which plaintiffs derivatively seek recovery, is the first claim for violation of fiduciary duty in paragraph "5". Everything following that paragraph purports to set forth abstract and conclusory claims of illegality under federal law, thus affording a purported vehicle for federal jurisdiction, although without any showing of injury to petitioner.

The short moving affidavit by petitioner's Treasurer states facts tending to show that there is no common nucleus of operative fact for the State claim and the purported federal claims (pp. 4a-13a). It states the facts of the minute shareholdings of respondents, making mandatory the relief under Section 627 of the Business Corporations Law (p. 5a).

The affidavit outlines the spectacularly successful investment record of petitioner, one of the best of all the investment companies in the world for the last five years, according to a recognized statistical authority (pp. 9a-10a). It is shown that the appreciation in value per share of petitioner has been more than four times that of the Dow-Jones Industrial Average over a period of years, and that in 1966 when that average declined 18.9%, petitioner's share value appreciated 3% (p. 9a).

The affidavit emphasizes the fact that petitioner is a "no-load" fund (p. 6a). As such, it is not the object of Securities and Exchange Commission attack and congressional attention, since as the S.E.C. report to Congress of December 2, 1966 ("Public Policy Implications of Investment Company Growth", 89th Congress, 2d Session, Union Calendar No. 1046, House Report No. 2337, hereinafter referred to as the "S.E.C. Report") states (p. 53):

> "From the small investor's point of view the sales load is by far the principal cost of a mutual funds investment. Most mutual fund investors are small investors, and the 8.5 percent sales load that they normally pay is—assuming that the net asset value of the fund's shares does not change—almost 19 times their pro rata share of the customary annual advisory fee of one-half of 1 percent." (Footnotes omitted).

Thus, should Congress adopt a 5% limitation on "sales loads" as recommended by the S.E.C. Report, petitioner's annual advisory fee, beginning in the first bracket at

8/10ths of 1%, and now in the 4/10ths of 1% bracket, will continue to present only a fraction of the expense to investors of a "load" fund, even after future remedial action by Congress with respect to the "load" funds (pp. 8a-9a).

The affidavit requests security for reasonable expenses in the amount of $100,000, including the expenses petitioner will incur in reimbursing the officers and directors who are co-defendants (pp. 5a-6a, 13a).

The affidavit makes clear that the defense of the state equity claim will be detailed, massive and expensive, whereas the purported federal claims, since they involve wholly different facts and narrow legal issues, will be relatively less expensive to defend before a jury (p. 13a).

Reasons For Granting the Writ

If petitioner is entitled to the protection of Section 627 of the Business Corporations Law of New York, which was enacted to prevent "strike suits" and to relieve corporations of the heavy burden of defending baseless actions brought for ulterior motives by persons with no real interest in the outcome, then relief must be granted on this petition, or it can never be granted.

This Court has held that in "diversity" cases, a federal court must apply a state security statute. *Cohen* v. *Industrial Loan Corporation,* 337 U.S. 541. As that case pointed out, if relief is not granted during the course of a derivative action, it will be too late after the action is successfully defended, because the corporation and the officers and directors whom it must indemnify will never be able to recoup the enormous expense of their successful defense. In effect, the basis of jurisdiction and the reason for relief were held to be the same.

One judge in the Southern District of New York has held expressly that the New York requirement for security for expenses must be applied in "pendent jurisdiction" cases as well as in "diversity" cases* Apparently, other courts have not passed on the question. Since this Court has never passed on the question, it ought to do so now, even in the absence of any express conflict among the circuits, since it is a question which will recur. Failure to apply the state security statutes will increase the flooding of federal courts with essentially state actions, which, as here, are garnished with various federal securities law labels as the ticket for admission to the federal court and the passport of evasion of well considered state statutes expressing the policies of the states.

The question will recur irrespective of any action by Congress to amend the Act and involves all federal statutes.

The Act expressly recognizes in Section 10(d) quoted *supra*, pp, 4-5, that a "no load" fund, such as petitioner American Investors Fund, which does not charge any sales load or commission, may pay an advisory fee of not more than 1% per annum of its net assets, even if only one director is "unaffiliated." If not more than 60% of the directors of an investment company are "affiliated persons," as that term is specifically defined in Section 2(a)(3) of the Act, there is no limit whatever on the amount or rate of the advisory fee in the federal statute.

The complaint is wholly silent as to the affiliation of directors, and it does not attack the truth of prospectuses and proxy statements showing petitioner has never had directors, more than 60% of whom were affiliated.

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* See *infra* p. 15. Another judge has followed this decision.

Thus, it is clear at the outset that a claim of an excessive fee, which the very terms of paragraph "5(b)" of the complaint show to be less than the only federal statutory maximum, cannot be entertained under federal law. The claim in paragraph "5" of the complaint, since it cannot allege a violation of federal law, is not, and can never be, anything more than a claim of violation of fiduciary duty by directors under New York corporation law.

That the real essence of the claim in paragraph "5" is a violation of state law, and state law only, makes it clear that this claim should never have been presented to a federal court, in the absence of diversity. Of course, had the claim been brought in the state court by these holders of approximately 50 shares out of 3,250,000 outstanding at the time this motion for security was brought, petitioner could have invoked Section 627 of the Business Corporations Law as a matter of right, and a New York court would have enforced its mandatory provisions (p. 5a).

Respondents recognized that their complaint was in essence one of New York law, since they expressly invoked in paragraph "1" of the original complaint "pendent jurisdiction" and "common law principles." (p. 14a)

This Court has recently reviewed the requirements for "pendent jurisdiction." In *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725, the Court stated:

> "The state and federal claims must derive from a common nucleus of operative fact."

The present case presents a complaint where the three claims are wholly unrelated. There is no "common nucleus of operative fact" among the three claims.

The complaint is a conglomerate. Nothing tending to prove or disprove the state claim of violation of fiduciary

duty with respect to the reasonableness of the advisory fee has any bearing whatever upon the second and third claims. The second claim herein (paragraphs "6" through "11"), is nothing but an abstract assertion that all of the directors are subject to "domination and control" (paragraph 8) and that they are "beholden" to the investment adviser for the "substantial emoluments derived from their positions" (paragraph "7"). There is not a single fact or "ground" alleged, as required by Rule 8 of the Rules of Civil Procedure, and nothing tending to show or to prove the first claim as to the unreasonableness of the advisory fee would have any bearing upon the second claim.

The third claim contained in paragraphs "12" through "20" is likewise unrelated to the first claim under New York law. That third claim merely alleges that petitioner has given brokerage business to a certain brokerage firm at the request of a very large shareholder of the Fund. There is no allegation that any of such brokerage business was unnecessary, or improvident, or that petitioner paid excessive brokerage fees. The third claim is nothing but a bald statement that it is illegal for petitioner to place brokerage business at the suggestion of a shareholder, followed by the further bald assertions that this constitutes "conversion" and a deprivation of benefits to petitioner.

Therefore, this conglomerate complaint is nothing more than an allegation that the advisory fees are unreasonable, to which the plaintiffs have seen fit to tack on highly speculative assertions as to the Act.

This Court said in *United Mine Workers* v. *Gibbs, supra* at 726:

> "Its [pendent jurisdiction's] justification lies in considerations of judicial economy, convenience and fairness to litigants; if these are not present a federal

court should hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them, Erie R. Co. v. Tompkins, 304 U.S. 64 (58 S. Ct. 817, 82 L. Ed. 1188). *Needless decisions of state law should be avoided both as a matter of comity and to promote justice between the parties, by procuring for them a surer-footed reading of applicable law.*" (Emphasis added, footnote omitted).

• • •

"Similarly, if it appears that the state issues substantially predominate, whether in terms of proof, of the scope of the issues raised, or of the comprehensiveness of the remedy sought, the state claims may be dismissed without prejudice and left for resolution to state tribunals."

Since respondents expressly invoked "pendent jurisdiction" in their original complaint, and since their amended complaint makes no change whatever except to delete such reference in the first paragraph, the further statement of this Court in *United Mine Workers* v. *Gibbs, supra,* at p. 727 is especially significant:

"The question of power will ordinarily be resolved on the pleadings. But the issue whether pendent jurisdiction has been properly assumed is one which remains open throughout the litigation. Pretrial procedures or even the trial itself may reveal a substantial hegemony of state law claims, or likelihood of jury confusion, which could not have been anticipated at the pleading stage. Although it will of course be appropriate to take account in this circumstance of the already completed course of the litigation, dismissal of the state claim might even then be merited. For example, *it may appear that the plaintiff was well aware of the nature of his proofs and the relative importance of his claims;* recognition of a federal court's wide latitude to decide ancillary questions of state law *does not imply that it must tolerate a litigant's effort to impose upon it what is in effect only a state law case.* Once it appears that a

state claim constitutes the *real* body of a case, to which the federal claim is only an appendage, the state claim may fairly be dismissed." (Emphasis added)

Two decisions in the Southern District of New York squarely support petitioner's position. Both cases involved mutual funds. A short, cogent opinion by Judge Edelstein carefully discussed and properly applied *United Mine Workers* v. *Gibbs, supra,* and *Cohen* v. *Beneficial Industrial Loan Corp., supra.* In *Mintz* v. *Allen,* 254 F. Supp. 1012, the court held (p. 1014):

"Both as a matter of law and as a matter of policy the court finds that State security requirement should be enforced (as to state causes of action only) by the federal courts in pendent as well as diversity jurisdiction cases.[2]"

"[1] Judge Weinfeld, relying on Phelps v. Burnam, 327 F. 2d, 812 (2d Cir. 1964) and Fielding v. Allen, 181 F. 2d. 163 (2d. Cir.) cert. denied, Ogden Corp. v. Fielding, 340 U.S. 817, 71 S. Ct. 46, 95 L. Ed. 600 (1950) has reached the same result. Kane v. Central American Mining & Oil, Inc. 235 F. Supp. 559, 567-569 n. 40 (S.D.N.Y. 1964). In both Phelps and Fielding however, jurisdiction over the non-Federal claims was based on diversity. In Kane, the argument urged in instant case was apparently not made."

Judge Bonsal has recently reached the same result in *Entel* v. *Allen* (64 Civ. 4048, S. D. N. Y., January 31, 1967) —— F. Supp. ——, reported in CCH Federal Securities Laws, ¶91, 886, expressly following *Mintz* v. *Allen, supra.*

The S.E.C. Report adds weight to petitioner's contention that only state law applies to reasonableness of advisory fees. It says (p. 139):

"Plaintiffs' counsel were not unmindful of the likelihood of an adverse judgment, since each fully litigated case had resulted in a judgment for defendants. And under the courts' interpretation of *applicable State*

law, obtaining a favorable result was no easy matter. The most modest of settlements seemed preferable to the risk of a trial which was likely to result in an adverse decision." (emphasis added)

The S.E.C. thus expressly recognized that what is involved in mutual fund litigation concerning advisory fees is "applicable state law."

The Report also stated at page 133:

"In most cases settlements were reached which provided for some reduction in advisory fees to be charged in future years. In only three cases did the termination result from a judgment on the merits based on an evidentiary record developed in an adversary proceeding. Each of the three fully litigated cases (Meiselman v. Eberstadt, decided in May of 1961,[138] Saxe v. Brady, decided in September of 1962,[139] and Acampora v. Birkland, decided in July of 1963)[140] held that the plaintiffs had failed to prove the fees legally excessive and resulted in a judgment for the defendants.[141] "

"[138] 39 Del. Ch. 563, 170 A. 2d 720.
"[139] 40 Del. Ch. 474, 184 A. 2d 602.
"[140] 220 F. Supp. 527 (D. Colo.)."
[141] Footnote omitted.

The *Saxe* v. *Brady* case, cited by the S.E.C., *supra,* contains a lengthy and thorough discussion of Delaware law. The only federal case cited by the S.E.C. applied Delaware law in the Colorado federal court.

Respondent's attorney, who verified the complaint and the amended complaint, is, of course, well aware that state law controls the gist* of this action and is likewise "well aware of the nature of his proofs and the relative im-

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* The present case contrasts with *J. I. Case Co.* v. *Borak,* 377 U.S. 426, where the gist of the complaint was a federally created right.

portance of his claims." *United Mine Workers* v. *Gibbs*, 383 U.S. at 727. At the University of Pennsylvania Law School Conference on Mutual Funds, held less than one month after he verified the complaint, Abraham L. Pomerantz, Esq. was a panel speaker. He is reported as saying (115 Univ. of Penn. L. Rev. 659, 753):

> "MR. POMERANTZ: I have had fourteen investment company cases and fourteen sets of depositions and/or cross-examinations of the independent directors, and in not one single case did any unaffiliated director ever respond 'Yes' to this type of question: When your fund grew from $100 million to $600 million, did you ever give any thought to making a comparison between your half of one per cent fees and somebody else's fees?
>
> No."

A few pages earlier (p. 740) Mr. Pomerantz had also recognized, in agreement with the S.E.C. Report (quoted *supra*, pp. 15-16), that "every stockholder's action charging excessiveness that has gone to trial has been nonsuited or dismissed * * *." These cases, of course, turned on what the S.E.C. called "applicable state law" (pp. 15-16, *supra*), and state law alone.

That the defense of this state law action will be equally successful is foreshadowed by the facts briefly outlined in the moving affidavit, paragraph 10 (pp. 8a-9a), showing the declining scale of advisory fees instituted when petitioner had barely crossed $10,000,000 in size.

But, in the meantime, petitioner is put to the expense of defending a state equity suit in the federal court, where plaintiffs have demanded a jury (p. 14a), without the protection of New York law where it is incorporated and where the federal forum is.

The mere fact that respondents have "jumbled" three wholly unrelated claims in a single count cannot permit them to escape New York law. In a diversity derivative action in which $100,000 security was upheld, Judge Friendly has said for the Court, *Phelps* v. *Burnham,* 327 F. 2d 812 (2d. Cir.) at p. 814:

> "... It is scarcely persuasive that, as appellant urges, the Complaint might have jumbled the two claims together; this might have made it harder to draw the order but would not have altered the essentials."

The artifice of jumbling state and federal claims in a single count should be no more successful in "pendent jurisdiction" cases than in "diversity" cases.

The "fourteen investment company cases" which respondents' attorney has brought (*supra,* p. 17), all of which must turn upon what the S.E.C. Report calls "applicable State law" (*supra,* p. 16) cannot have failed to inculcate that degree of forum awareness which *Erie R.R. Co.* v. *Tompkins,* 304 U.S. 64, sought to make supportive, rather than destructive, of state policy.

Until this Court at this stage of an action determines the important and unsettled questions presented, its decision in *Cohen* v. *Industrial Loan Corp., supra,* will remain only half effective. Transparently inappropriate federal labels will suffice to defeat state policy, to impose state law cases on federal courts, and to frustrate this Court's decisions.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

Dated: July 11, 1967

Respectfully submitted,

CLENDON H. LEE
Counsel for Petitioner
120 Broadway
New York, New York 10005

Of Counsel:

O'CONNOR & FARBER
120 Broadway
New York, New York 10005

Notice of Motion for a Protective Order

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 60

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.), JESUP & LAMONT and AMERICAN INVESTORS FUND, INC.,

Defendants.

SIRS:

PLEASE TAKE NOTICE that upon the annexed affidavit of John F. Newton sworn to the 15th day of February 1967, and upon the notice to take deposition upon oral examination of defendant George A. Chestnutt, Jr. dated the 30th day of January 1967 and upon the complaint, copies of which are hereto annexed, and upon all the proceedings heretofore had in this action, defendant American Investors

Notice of Motion for a Protective Order

Fund, Inc. by its undersigned attorneys will move this Court at Room 506, United States Courthouse, Foley Square, Borough of Manhattan, City and State of New York, on the 23rd day of February, 1967, at 10:00 o'clock in the forenoon, or as soon thereafter as counsel may be heard, for a protective order pursuant to Rule 30(b) of the Federal Rules of Civil Procedure conditioning defendant Chestnutt's examination before trial and all further proceedings herein relating to non-federal claims upon plaintiffs first posting $100,000 security for the reasonable expenses including attorneys' fees, which may be incurred by defendant American Investors Fund, Inc. in connection with the above entitled action and by the other parties defendant in connection therewith for which American Investors Fund, Inc. may become subject pursuant to Section 627 of the Business Corporation Law, to which security American Investors Fund, Inc. shall have recourse in such amount as the Court shall determine upon the termination of the action and further requiring plaintiffs to serve a written notice of the giving of said security upon American Investors Fund, Inc.'s attorneys and staying all other proceedings on the part of plaintiffs except to review or vacate said order until compliance with such order, or, in the alternative, dismissing alleged "pendent" state law claims for want of jurisdiction or as a matter of discretion, and for such other, further and different relief as to the Court may seem just and proper.

Notice of Motion for a Protective Order

Dated: New York, N. Y.
February 15, 1967

Yours, etc.

O'Connor & Farber

By /s/ Clendon H. Lee
A Member of the Firm
Attorneys for Defendant
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To:

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New York, New York 10005

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 60

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.), JESUP & LAMONT and AMERICAN INVESTORS FUND, INC.,

Defendants.

STATE OF NEW YORK,
COUNTY OF NEW YORK, *ss.:*

JOHN F. NEWTON, being duly sworn, deposes and says:

1. I am Treasurer of defendant American Investors Fund, Inc. ("the Fund"), a New York corporation. Plaintiffs have brought a "derivative" stockholders action against the Fund and the other defendants named in the complaint. This affidavit is submitted in support of the Fund's motion for a protective order conditioning all further proceedings herein including oral examinations before trial upon plain-

tiffs' first posting security for expenses in the initial amount of $100,000 in accordance with §627 of the New York Business Corporation Law, or in the alternative dismissing the state claims.

2. I am advised by the transfer agent of the Fund, The Bank of New York, that the plaintiffs are the record owners of approximately 50 shares of stock in the Fund standing in their names at an address in Brooklyn, New York. The complaint alleges that they bring this action "derivatively on behalf of the Fund." All of the directors of the Fund are named as defendants, including a former director. Other defendants include the investment adviser to the Fund, Chestnutt Corporation (as well as its dissolved predecessor American Investors Corporation), a brokerage firm, and various other defendants including The Fund of Funds, Ltd., which is a substantial shareholder of the Fund.

3. The Fund is a registered investment company under the Investment Company Act of 1940 ("the Act") having assets of approximately 110 million dollars. It has outstanding approximately 3,250,000 shares, each representing an equal interest in the Fund's total assets.

4. I have read the complaint and do not believe there is any merit to this action. The Certificate of Incorporation and By-Laws of the Fund provide in accordance with and subject to the limitations of the Business Corporation Law of New York that the directors, officers and employees of the Fund shall be reimbursed for their expenses, including legal fees, incurred in the defense of derivative shareholders' actions. All directors and a former director are named as defendants. I am advised that counsel will be retained by directors. Consequently, in addition to the

expense the Fund has already incurred, the Fund will immediately incur liability in substantial amounts to reimburse those officers and directors for expenses incurred by them.

5. The first paragraph of the complaint invokes "principles of pendent jurisdiction" and is said to be based "upon common law principles." I am advised by attorneys for the Fund that state law principles, in this case the law of New York where plaintiffs reside and the state of incorporation of the Fund, permeates the entire complaint. I am further advised that the purported federal claims are without merit and of dubious sufficiency. Thus, the only claim stated is in fact a New York claim, upon which a federal label has been attached.

6. The Fund is a "no-load" fund. That is, purchasers of shares pay no commission and acquire their shares at the net asset value per share. Shareholders may redeem at any time at the net asset value, without any payment of any commission or redemption charge. Since there are no salesmen earning commissions which cost the investor some 8% or 9%, the growth of the Fund depends upon its reputation for successful management. As hereinafter appears in detail, the growth by appreciation and by sale of additional sales reduces the advisory fee. Now that the Fund has crossed the $100,000,000 mark, the advisory fee on the asset value over that amount is only four tenths of one percent (0.4 of 1%), which is exactly half the rate of the advisory fee on the first $50,000,000. Thus, the continued growth of the value of the Fund's portfolio and the continued growth by sale of additional shares have the effect

of reducing the overall cost to shareholders of the investment advice furnished by the adviser.

7. The 50-odd shares held by the plaintiff out of the 3,250,000 outstanding have a fair value of no more than approximately $1,800 to $2,000, thus being a minute fraction of 1% of the Fund's outstanding shares and less than $50,000 in fair value. In view of the serious common law allegations in the complaint of violation of fiduciary duty attacking transactions involving millions of dollars, it will be necessary to conduct extensive preparation for trial, extensive discovery proceedings and to engage in a protracted law suit. Consequently, the expense to the Fund will be very heavy. The expense will be immediate, since the oral examination of a director and president of the Fund has already been noticed, even prior to joinder of issue. The expenses, including counsel fees, which the Fund will be required to pay and reimburse will also be heavy and will soon mount to at least $100,000 if the case proceeds as indicated. These heavy expenses are directly related to the "pendent jurisdiction" invoked in the complaint. I am advised that the narrow legal claims under federal labels are very much simpler to defend and litigate and will not require as heavy a financial burden to defend.

8. Since plaintiffs do not hold sufficient shares of the Fund to meet the standards of §627 of the Business Corporation Law, and since the Fund has already incurred expenses and will incur heavy expnse immediately, it is respectfully requested that the Court require the plaintiffs to furnish security in the amount of not less than One Hundred Thoustand Dollars ($100,000) pursuant to §627 of the Business Corporation Law.

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

9. There are, in essence, three things complained of. The first is that the advisory fee is too high and is not related to the services performed by the investment adviser. Counsel have informed me that only three cases have been dcided on the merits out of the many cases which have been brought against mutual funds and their advisers, and all three cases have been determined in favor of the defendants and have applied state law, two of them in Delaware and the other by a federal court in Colorado which applied Delaware law and quoted extensively from the opinion of the Delaware Chancellor.

The second matter complained of asserts that there is domination and control of the Fund, claiming in one breath that a large Swiss stockholder, defendant The Fund of Funds, Ltd., controls the Fund, and claiming contrary-wise in another breath that the Fund is controlled by its adviser, Chestnutt Corporation.

The third purported claim relates to brokerage fees on portfolio transactions. It is not alleged that the Fund engaged in "churning", or was overcharged, or paid any brokerage fees other than the standard, customary and prescribed brokerage fees. Yet it is claimed that payment of brokerage fees constituted "conversion" and a "rebate", and various wrongful and even criminal labels are attached thereto.

10. The records of the Fund show that it commenced the year 1964 with net assets of $11,040,000. At that time this small, no-load Fund was paying a flat 1% per year advisory fee. During that year a new contract was entered into effective June 30, 1964, providing the following advisory fee schedule:

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

Annual Rate	*Total New Asset Value*
0.8 %	First $50 million
0.6 %	Next $50 million
0.4 %	Next $100 million
0.3 %	Next $100 million
0.25%	Next $100 million
0.2 %	Next $100 million
0.15%	Next $500 million
0.10%	Excess of $1,000 million

This contract has been approved periodically by the Fund's shareholders including these individual plaintiffs who voted approval.

Since the Fund now has net assets of $110,000,000, it has now reached the third bracket of 0.4 of one percent, effecting an overall reduction in the cost to shareholders for the fee paid to the adviser.

No doubt the spectacular growth of this no-load Fund, not merchandised by persons seeking the customary 8% or 9% commission and not sold pursuant to "plans" with heavy "front-end loads", is due to the investment record of the Fund. For example in the year 1966, the net asset value per share (assuming re-investment of capital gain distributions) increased 3.0%, while the Dow Jones Industrial Average went down 18.9%. Thus, the investment adviser who is accused of performing services which "bear no relationship to the fees charged therefor," paragraph 5(i), was able in the chaotic markets of 1966 to perform services approximately 22% better than the Dow Jones Industrial Average referred to. Records in my possession show the Fund's increase in value per share from $10 per share in January of 1958 when the Fund made its first

investment to the end of the year, 1966. They show that (assuming re-investment of capital distributions) the value per share has increased 311.2%, whereas the Dow Jones Industrial Average has increased 75.6%. Thus, each shareholder of the Fund during the period has fared approximately 4 times as well as the Dow Jones Industrial Average.

I am advised by counsel that even if the Federal statute should be amended to create for the first time a federal standard of "reasonableness", as contrasted with the state standard, for the fees charged by investment advisers that the Securities and Exchange Commission has recommended that investment results be taken into account. As will be discussed more fully in the brief to be submitted in support of this motion, the Securities and Exchange Commission stated in a recent report to Congress (p. 145):

> "Thus the sustained investment performance of a company would be an appropriate consideration in evaluating the reasonableness of its advisers compensation."

The "sustained investment performance" of American Investors Fund, Inc. is shown by "Exhibit A" hereto, a four page supplement to "Investment Companies 1966" published by Arthur Wisenberger & Co. On the third page appears the fact that for the five-year period, 1962-1966, the appreciation per share of American Investors Fund was 145.3%, by far the best of all the funds listed.

Thus, even if Congress should create a federal body of law which for the first time would govern the fees paid to investment advisers, it is clear that the record of results would permit this no-load fund to continue the payment

of fees in accordance with the decreasing scale which the Fund has been paying.

Nevertheless, and without regard to the certainty of ultimate vindication in equity, in morals and at law, the defense of this action will require extensive and protracted preparation to meet charges of violation of state law. This will be very expensive to the Fund and to its directors whom the Fund is required to reimburse. I do not believe there is any relationship between this state claim and the other allegations in the complaint.

11. The second claim in the complaint, in the segment of allegations contained in paragraphs 6 through 11, does not relate in any way to the first claim that the advisory fee is unreasonable under state law. This second claim apparently seeks declaratory relief upon the bare assertion that a Swiss-based mutual fund dominates and controls the Fund. I am advised by counsel that even if the second claim were to be held to be sufficient under federal law, that nothing relating to the first claim would be relevant or material to prove this second claim. Since this motion is not directed to the sufficiency of the federal claims set forth in the second and third segments of the complaint, I simply want to deny plaintiffs' completely unfounded assertions.

I have inquired of other officers and directors of the Fund and its investment adviser and I am informed that at no time has there been any attempt made by The Fund of Funds to dominate or control the management or policy of the Fund. Only one new director, defendant Warren K. Greene, has joined the board of directors of the Fund since The Fund of Funds made its first purchase of shares in 1964. Mr. Greene was employed by the Fund's investment

adviser in January 1965, and he became a director of the Fund in 1966. From 1959 to 1965 Mr. Greene was employed by First Boston Corporation. He has advised me that he has had no connection or dealings whatever with The Fund of Funds or with any of its affiliates. The tenure of the other board members antedates by several years the first purchase of shares in American Investors Fund by The Fund of Funds.

The Fund's Certificate of Incorporation from its inception, some five years before The Fund of Funds commenced buying shares of the defendants' stock, has provided that if the Board of Directors determined that it was in the best interests of the remaining shareholders of American Investors Fund, it may pay a redemption in whole or in part in kind by distribution of securities from its portfolio. Thus, even if it were to be assumed that a substantial and concentrated shareholding could possibly influence the Fund by massive redemption or threatened massive redemption, the Fund is in a position where it may disregard any conceivable threatened influence with complete impunity and without the slightest risk, market or otherwise, to its remaining shareholders.

Moreover, The Fund of Funds has advised American Investors Fund that in keeping with its policy of not investing in any fund for the purpose of obtaining and exercising control that it has adopted a policy of voting shares in the same proportion that other shares are voted on particular issues, except 3%, which it reserves the right to vote in such manner as The Fund of Funds sees fit.

I do not know of any facts relevant or material to the first state law claim which have any bearing upon the asserted claim under federal law that the Fund is dominated by a foreign shareholder.

Affidavit of John F. Newton Sworn to February 15, 1967 in Support of Motion

12. The third claim asserts violations of federal law, with respect to brokerage commissions (paragraphs 12 through 20).

I do not understand how this claim involves the Fund, since the allegations relate to supposed relationships between The Fund of Funds and a brokerage firm.

Irrespective of what the facts may be, it is clear that the reasonableness of the advisory fee under state law does not involve the same facts as the relationships between The Fund of Funds and a brokerage firm.

13. In conclusion, it is clear to me as principal financial officer of the Fund that there will be an immense amount of work to do to prepare the defense of the alleged state claim. I know of no factual connection between the state claim and the two federal claims relating to foreign domination and brokerage. For the reasons set forth herein, I respectfully submit that the plaintiffs should be required to furnish security in the amount of $100,000, or in the alternative that the state claim be dismissed.

/s/ JOHN F. NEWTON
John F. Newton

Sworn to before me this 15th day of February 1967.

/s/ EDNA M. MILBERY
Notary Public

EDNA M. MILBERY
Notary Public, State of New York
No. 24-7982800
Certified in Kings County
Cert. filed with New York County
Term Expires March 30, 1968

Complaint

(Original)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 60

PLAINTIFFS DEMAND TRIAL BY JURY

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, ELIZABETH SULLIVAN, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION, THE FUND OF FUNDS, LTD., I.O.S., LTD. (S.A.), JESUP & LAMONT and AMERICAN INVESTORS FUND, INC.,

Defendants.

Plaintiffs, by their attorneys, Pomerantz Levy Haudek & Block, for their complaint, allege upon information and belief, except paragraph "2", which is alleged upon knowledge:

1. This action arises under the Investment Company Act of 1940, 15 U.S.C. §§ 80 a-1, et seq. (the "Act") and common law principles. The jurisdiction of the court is based on the Act and on the principles of pendent jurisdiction.

2. (a) Plaintiffs jointly are shareholders of defendant, American Investors Fund, Inc. (the "Fund") and have been shareholders since at least 1963 and at the times of the wrongs complained of herein.

(b) Plaintiffs bring this action derivatively on behalf of the Fund and representatively on behalf of themselves and all other shareholders of the Fund similarly situated.

(c) This action is not brought collusively to confer upon this court jurisdiction which it otherwise would not have.

3. The Fund is a New York corporation. It is and at all times relevant herein has been registered under the Act as a diversified open end management investment company.

4. (a) The individual defendants, other than Elizabeth Sullivan, comprise the Fund's board of directors. Elizabeth Sullivan has been a director of the Fund during the times of the wrongs complained of herein.

(b) In addition to their being directors of the Fund, defendant, George A. Chestnutt, Jr., is president of the Fund, defendant, Stanley L. Sabel, is vice-president and secretary of the Fund, and Elizabeth Sullivan has been, during the times of the wrongs complained of, treasurer of the Fund, and is presently assistant-treasurer of the Fund.

5. (a) Defendant, Chestnutt Corporation, a Connecticut corporation, is the successor in interest to American Investors Corporation, the investment adviser of the Fund. Defendant, George A. Chestnutt, Jr., is president, Treasurer and a director of Chestnutt Corporation and American Investors Corporation, and owns about forty-six (46%)

percent of the voting stock of each corporation. Defendant, Stanley L. Sabel, is vice-president, secretary and a director of Chestnutt Corporation and American Investors Corporation, and owns about sixteen (16%) percent of the voting stock of each. Defendant, John Currier, owns about two (2%) percent of the voting stock of Chestnutt Corporation and American Investors Corporation. Defendant, Elizabeth Sullivan, is assistant to the president of Chestnutt Corporation and American Investors Corporation.

(b) The Fund pays to Chestnutt Corporation, and has paid to American Investors Corporation, pursuant to investment advisory contracts, an annual advisory fee equal to .8% of the first $50,000,000 of net assets of the Fund; .6% on the next $50,000,000; .4% on the next $100,000,000; .3% on the next $100,000,000; .25% on the next $100,000,000; .2% on the next $100,000,000; .15% on the next $500,000,000, and .10% on all net assets in excess of $1,000,000,000.

(c) For the years ending December 31, 1963, 1964 and 1965, and the first six months of 1966, the Fund paid to American Investors Corporation investment advisory fees of $93,347.00, $187,083.00, $337,626.00 and $248,443.00, respectively.

(d) The huge increase in the amounts of the invesment advisory fee since 1963 has been due to the sharp rise in the net assets of the Fund. This rise has been due in large part to the sale of additional Fund shares to the public, which has provided substantially no benefits to the Fund and its shareholders. Despite the sharp rise in the amounts of the investment advisory fees, the expenses incurred by American Investors Corporation and Chestnutt Corporation in rendering investment advice and performing its

other management duties have remained substantially the same.

(e) Other managers and investment advisers did and do perform similar and more extensive duties for other investment companies at rates substantially below those charged by American Investors Corporation and Chestnutt Corporation to the Fund.

(f) The investment advisory fee paid by the Fund is one of the highest percentage fees paid by any open end investment company of which public information is available.

(g) The ratio of total operating expenses of the Fund to its average net assets (its "expense ratio") was approximately 1.2% in 1965, and was of similar magnitude in earlier years. It is grossly excessive and is one of the highest incurred by any investment company. It is far larger than the expense ratio of investment companies of comparable size to the Fund.

(h) In 1965 the operating expenses of the Fund consumed about sixty-six (66%) percent of the investment income of the Fund.

(i) The services performed by American Investors Corporation and Chestnutt Corporation for the Fund bear no relationship to the fees charged therefor.

6. (a) Defendant, The Fund of Funds, Ltd., a Canadian corporation, owns approximately thirty-six (36%) percent of the capital stock of the Fund.

(b) Defendant, The Fund of Funds, Ltd., is controlled by defendant, I.O.S., Ltd. (S.A.) ("IOS"), a Panama corporation, by reason of ownership by IOS of all of The Fund of Funds, Ltd.'s voting stock.

7. Defendants, John Currier, Frank G. Fowler, Jr., Warren K. Greene, Richard W. Radcliffe and Francis L. Veeder, obtained their positions with the Fund through the influence and action of defendants, Chestnutt, Sabel, American Investors Corporation, Chestnutt Corporation, The Fund of Funds, Ltd. and IOS and are beholden thereto for the substantial emoluments derived from their positions.

8. Chestnutt Corporation and American Investors Corporation are able to, and do, dominate and control the Fund and its personnel, its policies and its board of directors. By reason of such domination and control, § 10 (a) of the Act has been and continues to be violated.

9. By reason of the aforesaid domination and control the investment advisory contracts are and have been illegal and void and in violation of § 15 of the Act, and the payment of investment advisory fees thereunder is and has been illegal. Such shareholder approval of the investment advisory contracts as have been obtained has been procured through concealment of the aforesaid domination and control in violation of § 20 of the Act and is therefore void and of no effect.

10. The investment advisory fees paid by the Fund to American Investors Corporation and Chestnutt Corporation are excessive and constitute waste and spoliation of the Fund's assets in violation of the Act.

11. By reason of the aforesaid violations of the Act, the investment advisory fees paid by the Fund to American Investors Corporation and Chestnutt Corporation have been and are illegal.

12. The Fund of Funds, Ltd. and IOS are able to, and do, dominate and control the Fund and its personnel, its policies and its board of directors, with respect to the allocation of the Fund's brokerage.

13. As a result of the domination and control of the Fund by IOS, brokerage orders of the Fund have been and are placed at the request of IOS with the defendant, Jesup & Lamont, a New York partnership engaged in the securities business.

14. The basis for allocation of brokerage business to Jesup & Lamont was and is directly related to the size of the investment of The Fund of Funds, Ltd., in the Fund.

15. Commissions paid to Jesup & Lamont by the Fund were $111,142.00 in 1964 and $137,692.00 in 1965, and $29,184.00 in the first six months of 1966.

16. IOS and affiliated and related persons and organizations of IOS have derived substantial benefits from the Fund brokerage directed by IOS to Jesup & Lamont.

17. The aforesaid benefits include the following:

(i) Jesup & Lamont has furnished to IOS research, investment advisory and investment banking services, and Schroeder Boulton, a partner of Jesup & Lamont, has agreed to and has become a member of the board of directors of The York Fund, Inc., a registered investment company all the stock of which is owned by The Fund of Funds, Ltd. and the management company of which is controlled by IOS.

(ii) Mrs. Gloria Martica Clapp, the registered representative employee of Jesup & Lamont who is credited

by that firm with all commissions received by or given-up to the firm as a result of the designations made by IOS, has arranged for the deposit with Fiduciary Trust Company, Ltd., Nassau, the Bahamas (Fiduciary), of most of the amounts paid to her by Jesup & Lamont, as her share of the brokerage commissions on all business directed to it or give-ups paid to it at the request of IOS. Fiduciary, in turn, has transferred substantial sums of money to banks controlled by IOS or to banks which have material banking relationships with IOS.

(iii) Mrs. Clapp and her husband, Samuel F. Clapp, directly and indirectly through J. H. Crang & Co. (Nassau) Ltd., have assisted IOS in obtaining work entry permits for its salesmen to permit them to sell the IOS Investment Program in Nassau, the Bahamas.

(iv) Samuel F. Clapp, directly and indirectly through Fiduciary and J. H. Crang & Co. (Nassau) Ltd., assisted in the procurement for IOS of subscribers to its IIT investment advisory service, "International Economic and Market Reports," at a subscription price of $2,500 per month ($30,000 per year) per subscription. These subscribers have paid to IOS substantially in excess of $100,000.

(v) Samuel F. Clapp has arranged for financial institutions to deposit more than $7,000,000 with banking institutions controlled by IOS or in which IOS has an interest.

(vi) Samuel F. Clapp, a member of the Bar of Massachusetts, directly and indirectly through Fiduciary, has provided IOS and its affiliated companies and persons with legal advice and a variety of other valuable services relating to the business affairs of IOS.

(vii) Samuel F. Clapp has introduced IOS, and caused IOS to be introduced, to persons with whom IOS or various of its subsidiaries have enjoyed valuable relationships.

18. As a result of such direction of brokerage, the Fund has been deprived of substantial benefits which otherwise would accrue to it.

19. The direction of brokerage commissions to Jesup & Lamont, as above-described, has constituted and continues to constitute a rebate to The Fund of Funds, Ltd., through its affiliate IOS, from the current public offering price of Fund shares in violation of § 22 of the Act.

20. The payment of such brokerage commissions to Jesup & Lamont has constituted and continues to constitute an unlawful and willful conversion by The Fund of Funds, Ltd., IOS, Jesup & Lamont and the individual director defendants of the monies, funds, property and assets of the Fund to the use of The Fund of Funds, Ltd., IOS and Jesup & Lamont, in violation of § 37 of the Act; and gross abuse of trust, gross misconduct, willful misfeasance, bad faith, gross negligence and a reckless disregard of their fiduciary duties by the Fund's officers and directors in violation of the duties which §§ 10, 17(h) and 36 of the Act impose upon them; and constitutes a waste and spoliation of the Fund's assets for the benefit and profit of IOS, The Fund of Funds, Ltd. and Jesup & Lamont, but to the harm and detriment of the Fund.

21. Demand upon the Fund's board of directors to bring this action would be futile and is unnecessary for at least the following reasons:

(a) The directors are defendants herein and participated or acquiesced in the wrongs alleged and are liable therefor;

(b) Defendants, American Investors Corporation, IOS and The Fund of Funds, Ltd., control and dominate the Fund and its board of directors; and

(c) The institution of the action by the Fund's directors would place it in hostile hands and would prevent its effective prosecution.

22. Demand upon the Fund's shareholders to bring this action would be futile and is unnecessary for at least the following reasons:

(a) The wrongdoings alleged herein violate the Act and are a waste of the Fund's assets and hence are incapable of shareholder ratification.

(b) Under New York law and under the charter and by-laws of the Fund, the management of its affairs, including the bringing of suits, is entrusted to the board of directors, not to the shareholders. The shareholders cannot by resolution or otherwise require the Fund or its board of directors to bring an action.

(c) Even if the shareholders were to direct the board of directors to bring this action, its control would lie in the hostile hands of the directors, who could not be entrusted with its effective prosecution.

(d) The Fund has many thousands of shareholders scattered all over the United States and foreign countries. Their identity is subject to frequent changes. To secure action from the shareholders would require a proxy fight with the management, which controls the proxy machinery of the Fund, and uses the Fund's moneys in preparing and mailing proxy material and soliciting the shareholders' votes. The conduct of a proxy fight by plaintiff would entail prohibitive expenses and would cause undue loss of time, with the danger that the claims alleged might become barred by the Statute of Limitations or laches.

WHEREFORE, plaintiffs pray for judgment:

(a) Declaring the contract employing Chestnutt Corporation as investment adviser of the Fund to be void;

(b) Enjoining defendants, temporarily and permanently, from continuing their unlawful conduct alleged herein;

(c) Requiring defendants other than the Fund to account for and pay to the Fund the advisory fees received by them since 1963;

(d) Requiring defendants other than the Fund to account for and pay to the Fund the brokerage commissions paid to Jesup & Lamont since 1963;

(e) Requiring the defendants other than the Fund jointly and severally to account for and pay to the Fund for their profits and gains and its losses;

(f) Awarding the plaintiffs the costs and expenses of this action including reasonable counsel fees; and

(g) Granting plaintiffs such other and further relief as may be just.

POMERANTZ LEVY HAUDEK & BLOCK

by /s/ ABRAHAM L. POMERANTZ
Member of Firm
Attorneys for Plaintiffs
Office & P. O. Address
295 Madison Avenue
Borough of Manhattan
City of New York 10017

Complaint

STATE OF NEW YORK,
COUNTY OF NEW YORK, *ss.:*

ABRAHAM L. POMERANTZ, being duly sworn, deposes and says that he is a member of the firm of POMERANTZ LEVY HAUDEK & BLOCK, the attorneys for plaintiffs herein and has his office at 295 Madison Avenue, in the City of New York, County of New York; that he has read the foregoing complaint and knows the contents thereof and that the same is true of his own knowledge except as to matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true; that the reason why this verification is made by deponent instead of by plaintiffs is because plaintiffs are not within the County of New York, which is the county where deponent has his office. Deponent further says that the grounds of his belief as to all matters in said complaint not stated upon his knowledge are based upon his general investigation of the facts of this case.

/s/ ABRAHAM L. POMERANTZ
ABRAHAM L. POMERANTZ

Sworn to before me this
6th day of January, 1967.

DONNAGENE BURFIELD
Notary Public, State of New York
No. 24-5523665
Qualified in Kings County
Certificate filed in New York County
Commission Expires March 30, 1968

Amended Complaint

(First paragraph only, remainder of amended complaint identical to original complaint)

1. This action arises under the Investment Company Act of 1940, 15 U.S.C. §§ 80 a-1, et seq. (the "Act"). The jurisdiction of the court is based on the Act.

Memorandum Decision and Order of District Court

Rosalind Fogel and Gerald Fogel v. *George A. Chestnutt, Jr., et al.*, 67 Civ. 60, Civ. Mot. Cal. March 2, 1967 No. 51

Whether or not the amended complaint states a federal claim must, of course be determined on the face of the pleading, without regard to whether its allegations are true.

Brown v. *Bullock,* 294 F.2d 415 (2d Cir. 1961)

In my opinion, the allegations of the amended complaint with respect to the claimed illegality of the investment advisory contracts and the fees paid thereunder, contracts which are alleged to have been made as a result of the domination and control of the fund and its directors by the investment advisor, are sufficient to state a claim for violation of the Investment Company Act within the rule laid down in *Brown* v. *Bullock, supra.* It may be noted that since that case was decided in 1961, there has been a growing trend in favor of upholding federal jurisdiction in securities cases over claims which arguably could have been thought to charge merely a violation of state law. See *Brod* v. *Perlow,* Docket No. 31028 (2d Cir. March 27, 1967) which

involved Section 10(b) of the Securities Exchange Act of 1934.

Since the other claims alleged in the amended complaint are concededly federal, defendant is not entitled to a bond.

Fielding v. *Allen,* 181 F.2d 163 (2d Cir. 1950), *cert. denied,* 340 U.S. 817 (1950)

It also follows that the claims based upon the alleged illegality of the investment advisory contracts and the advisory fees should not be dismissed.

Motion denied.

So ordered.

Dated: March 30, 1967

EDWARD C. MCLEAN
U. S. D. J.

Order of Affirmance of Court of Appeals

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the eighth day of May, one thousand nine hundred and sixty-seven.

Present:

HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,

Circuit Judges.

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs-Appellees,

—v.—

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants-Appellants.

A motion having been made herein by counsel for the appellees to dismiss the appeal for lack of jurisdiction or to summarily affirm the order of the District Court,

Upon consideration thereof, it is

Order of Affirmance of Court of Appeals

Ordered that said motion to dismiss be and it hereby is denied.

Further ordered that the order of the United States District Court for the Southern District of New York be and it hereby is affirmed with costs to the appellees.

A. DANIEL FUSARO
Clerk